S. HRG. 110–959

THE STATE OF THE BANKING INDUSTRY

HEARING

BEFORE THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

THE STATE OF THE BANKING INDUSTRY

TUESDAY, MARCH 4, 2008

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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C O N T E N T S

TUESDAY, MARCH 4, 2008

WITNESSES

Additional Material Supplied for the Record

THE STATE OF THE BANKING INDUSTRY

TUESDAY, MARCH 4, 2008

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:08 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order. My apologies to our witnesses and my colleagues here for being a couple minutes late.

I believe Senator Shelby will try and get by. There is a large Alabama meeting this morning, I think regarding the recent announcement of the fuel tanker issue, and Alabama has a strong interest in that. And for that reason, he will not be here, at least for a while this morning.

What I will do here is I will begin with an opening statement. I will turn to any other members who would care to make a brief opening comment. I would like to, if we could, get to the questions and hear from our witnesses this morning. I want to thank all of them for participating.

The Committee this morning examines the state of the banking industry in our Nation. Such an examination by this Committee could not be more important or timely, in my view. It is important because our first duty, obviously, as legislators on this Committee is to ensure that insured depository institutions operate in a safe and sound manner. These institutions currently hold over $4.3 trillion in deposits that are insured by the American taxpayer. Therefore, the taxpayer, of course, has a right to know that the appropriate agencies are ensuring that any risks to those deposits are being managed prudently and with taxpayers' ultimate liability in mind.

I well remember sitting on this dais two decades ago—in fact, I think Senator Shelby was here, and others—cleaning up the mess caused by the reckless and wanton practices in the savings and loan industry. Those practices and the regulatory failures that allowed them to occur required a taxpayer bailout of some $150 billion. Those were very difficult days on this Committee. None of us, not a single person on this Committee, nor, I would suggest, any one of our colleagues, wants to go through that kind of exercise again, ever again. That is why this hearing is not only important but I think timely as well.

Credit markets are experiencing unprecedented disruptions right now. The markets for mortgages, credit cards, student loans, auto loans, corporate debt, municipal debt—in short, for all of the economic activities that are indispensable to growth and prosperity—these markets have chilled and in some cases have frozen entirely. These markets have seized up mostly as a direct result of problems in the subprime market. Recent estimates indicate that insured depositories and other financial institutions could lose an additional $300 to $400 billion due to exposure to mortgages, residential as well as commercial.

It is no surprise, therefore, that many of these institutions have sought infusions of over $30 billion in capital from foreign sovereign wealth funds since November last year. The federally insured banks, thrifts, and credit unions of our Nation are not just another group of financial intermediaries. Their success or failure is not merely of concern to their employees and shareholders. It should be and must be a concern for all of us because these institutions in a very real sense form the cornerstone of our Nation's economic foundation. If these lenders do not or cannot lend, then our economy cannot and will not grow, obviously.

President Kennedy is reported to have once said that if the economy is wrong, then nothing is right. If that is the case, then it is no less true that if the banking industry is wrong, then the economy is not right as well. The regulatory agencies that oversee this industry, therefore, play an indispensable role not only in the economic activities of the lenders they oversee, but in the economic life of our Nation. They do not merely apply and enforce the laws, as important as that job is; and they do not only ensure that the deposits which are insured by the American taxpayer are managed in a safe and sound manner, though they do that as well; fundamentally, you all serve as the gatekeepers of credit for the entire economy of our Nation. That is an awesome responsibility, and the men and women who work at our Nation's financial regulatory agencies understand that responsibility, and, by and large, they discharge those duties with diligence and with distinction, I would add.

But their dedication is not tantamount to infallibility. That point was made a year and a half ago when Senators Allard and Bennett convened hearings on irregular practices in the mortgage lending industry. I have commended them before—and I do so again this morning—for those hearings, which were prescient in many ways. The point was made again a year ago when this Committee convened a hearing to examine the turmoil in our Nation's mortgage markets. At that time I detailed what I termed "the chronology of neglect" by Federal regulators, principally the Federal Reserve under previous leadership. We presented evidence that the Federal Reserve examiners knew as far back as late 2003 of the deterioration of lending standards and the origination of adjustable rate and nontraditional mortgages. Yet the Fed did nothing to intervene, in my view. On the contrary, its Chairman at the time actually encouraged such loans. But then he simultaneously embarked on a series of interest rate hikes that would make adjustable rate mortgages less affordable to homeowners.

The impact of these policies is now felt, of course, by millions and millions of American consumers who face interest rate spikes that have led or will lead to foreclosure. It is felt by millions more who cannot obtain mortgage credit because the market for subprime and jumbo loans has seized up. It is felt by entrepreneurs who cannot obtain loans or other forms of financing because lending institutions are in a virtual credit lockdown. And it is felt by the lenders themselves, obviously, who are struggling in ways that they have not struggled in recent memory.

It is no wonder that the Fed's own witnesses at a hearing before this Committee last year said that, in retrospect, his agency—and I quote—"could have done more sooner" to address predatory mortgage lending practices.

Again and again, the question has been asked over the past year, as our credit markets have grown increasingly impaired: Where were the regulators? Why didn't they do more? Were they asleep at the switch? And when the alarm went off, did they merely hit the snooze button?

Four years ago, Senator Shelby convened an oversight hearing similar in purpose to today's hearing. At the time, the Federal agencies represented here this morning hailed innovations in risk management that enabled banks to better quantify risks and take other corrective measures to contain undue risks. They pointed to the second markets and newly developed structured finance products as tools that would help banks more effectively manage and diversify their risks. In the words of the then-Comptroller of the Currency, bank supervision would provide—and I am quoting—"a layer of protection against the challenges posed by our changing economy."

Four years later, we want to know what happened. What happened to the newfangled risk management innovations that were supposed to sound an early warning about reckless lending practices? What about the promise of securitization as a way to manage credit risk? Where was the layer of supervisory protection against excessive risk? Why didn't you more vigorously enforce good, old-fashioned, common-sense underwriting where a loan is made based on a borrower's ability to pay? And what are you doing now today to protect against new risks posed by instruments such as credit default swaps, trillions of which are held by the institutions you regulate?

I have read your testimony, and you seem to suggest that you will study what went wrong here. You have all said that we need to get back to the fundamentals, that we need to return to core practices, that we need to revive the way banks manage risk, underwriting, and capital. But studying the problem is not enough, and I want to see some meaningful and substantial action from all of you as soon as possible.

Specifically, I want to know what you intend to do to change what has been lax oversight of underwriting standards. I want to know what steps you intend to take to make sure that we rethink the assumptions underlying Basel II prior to its implementation. And I want to know what specific changes to the supervision of bank risk management you intend to implement moving forward.

I intend to reconvene this panel within 60 days to hear your responses to these very important questions. These are legitimate questions, important questions, questions that American taxpayers have every right to ask and have answered for them.

We appreciate the willingness of our witnesses, obviously, to appear today to help provide these answers. I am grateful to all of you.

Let me turn to Senator Bennett if he has any opening comments he would want to make, and my other colleagues as well, and then we will hear the testimony.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you very much, Mr. Chairman. I think you have outlined the problem extremely well. Let me make two very quick comments.

First, in this morning's Wall Street Journal, in an article that references today's hearings, the authors of the article say, if I may quote, "Today in Washington, D.C., the Senate Banking Committee is expected to grill Federal regulators on what went wrong. Did banks know how much risk they were taking? Did they know how much capital they needed to cushion them from sour loans? Did they prepare themselves adequately for the evaporation of liquidity or their ability to easily sell their securities or loans? The answer to all three questions appears to be no."

I think that is as good a summary of where we are and why we are here, and I add to that this personal anecdote, and I shall not disclose the individual because it was a one-on-one conversation between the two of us, and I do not suppose he would want me to violate the confidentiality of that conversation. But a very significant official from another country was in my office talking about the impact of all of this on the banking system in his country. And as he was describing the chain of events that led up to the crisis, he said, "They bought the package"—speaking of the banks in his country, "They bought the package on the basis of the rating that had been given it by nationally recognized rating agencies, and they did not know what was in it." And he kind of innocently did not realize what he was just saying, and now that they realize that in the package there were a bunch of subprime loans and they are going to have to change their capital structure to deal with this, and then with a sense of urgency and almost terror in his voice, he said, "Senator, the bank in my hometown is going to go bankrupt over this. They bought a package based on AAA ratings, and now they are going to go bankrupt."

And, unfortunately, I did not have any consoling words for him or reassurances that it was, in fact, not going to happen.

So the only additional comment I will make to your excellent opening statement, Mr. Chairman, is that this is not confined to the United States. This is spreading, and the three questions asked in the article very much applied to the foreign official that was in my office. The answer to the questions was clearly no, they did not know, and we are here to do whatever we can to try to help people in the future know what they are buying and what they are doing. It would be one thing to say to them, well, they bought a package without reading the fine print and they deserve what they got. But they did at least look at the overall risk, looked at the ratings that they got, and thought they had done some due diligence. Clearly, they did not do enough, and this hearing will help us deal with that problem.

Chairman DODD. Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Well, thank you, Mr. Chairman. I think this is a well-timed and very important hearing. You have made some excellent points, and just let me briefly say that there have been estimates recently by UBS that this whole financial crisis is on the order of $600 billion, and to date, banks, financial institutions, recognize roughly $160 billion. So we have a long way to go to work out this problem. And the difficulties and consequences that Senator Bennett alluded to, small banks across the world and across the United States, in communities and organizations and individuals will feel this pain dramatically.

So I think we have two major challenges. One is to solve this liquidity crisis if we can, or at least prevent it from further exploding, and also make sure we do not repeat what seems to be, in hindsight at least, oversights and regulatory gaps that allowed the situation to develop.

It would be great, as the Chairman suggested, if we were still in a world of good, old-fashioned underwriting standards where you knew your borrower and you kept the paper in your files and you had a vested interest in making sure the mortgage was paid and the terms were worked out. But in the world of securitization and globalization, that seems to be more nostalgic than anything else.

But in this new world, we have to recognize that perhaps regulation is more important, and that is why I think when we talk about Basel II and others, where the framework would be self-evaluation by financial institutions and credit rating agencies, we have to take a pause, at least, to ensure we do that right.

As we go forward, I think we have to look at this securitization process. It is a financial instrument that is not going to go away, or a financial technique that is not going to go away. But, again, it puts, I think, more pressure on regulators to get right, to look carefully at the off-balance-sheet instruments that banks are holding, and vehicles. And then we have to, I think, have much more financial transparency. But the purpose of this hearing I think is necessary.

I have not been here as long as the Chairman or my colleagues, but after Enron, I thought we had—and Sarbanes-Oxley, I thought we had gone a long way in directing that steps be taken to account for off-balance-sheet transactions. That was one of the great problems with Enron. They had all these vehicles, Raptors, et cetera. It turns out that, I guess, we did not get it that time. We have got to get it this time. I think also 2 years ago, when Congress passed legislation giving the Federal Reserve the authority to pass rules with respect to what types of paper, what types of mortgage loans, what standards, et cetera, that was just recently enacted by regulations by the Fed—many, many years after it should have been put in place. So this is an opportunity, once again, to do what I think should be done.

Thank you.

Chairman DODD. Senator Dole.

STATEMENT OF SENATOR ELIZABETH DOLE

Senator DOLE. Thank you, Chairman Dodd, for holding this important hearing on the state of the banking industry, and I want to start off by saying a few words about Sheila Bair, the Chairman of the Federal Deposit Insurance Corporation.

Sheila has a long history of public service that includes working as deputy counsel and counsel when my husband was Senate Majority Leader. And, Sheila, I want to thank you for your continued service to the public and the vital role that you are playing to assure competence and confidence in this volatile housing and financial market. It is a real pleasure to work with you in a professional way and always to see you.

As we know oh so well, over the past 6 months our financial institutions have been shaken by the subprime lending markets. These institutions have been pressured by write-downs, and their fourth quarter earnings decreased significantly. The Office of Thrift Supervision reported that the thrift industry posted a record $5.2 billion fourth quarter loss. Additionally, the two biggest banks in North Carolina—Bank of America and Wachovia—reported that their earnings fell in the fourth quarter by 95 percent and 98 percent, respectively.

Last week, the FDIC classified 76 banks as problem institutions for the fourth quarter of 2007. This is up from 65 in the third quarter, which underscores the growing number of banks that are showing signs of strain. FDIC is taking steps to brace for a potential increase in failed financial institutions. I also applaud the FDIC for its prospective thinking and planning for future unforeseen circumstances that could adversely impact our banking infrastructure.

Additionally, with respect to the current regulation of financial institutions, it has come to my attention that some smaller banks in particular are overburdened by compliance with Sections 404 and 302 of the Sarbanes-Oxley corporate accountability law. These financial institutions are already highly regulated, and it has become increasingly apparent that these additional regulations, while well intended, only increased the cost of doing business.

Today, I will introduce, Mr. Chairman, the Regulatory Relief and Fairness Act, legislation that would allow qualified financial institutions to voluntarily opt out of Sections 302 and 404 of Sarbanes-Oxley. There is companion legislation in the House of Representatives introduced by Congressman Walter Jones. I hope at a minimum the legislation serves as a catalyst for more debate in this Committee with respect to comprehensive regulatory relief reform.

Again, I want to thank all of our witnesses for being here today, and I look forward to working with you on these and other important matters.

Thank you.

Chairman DODD. Thank you very much.

Senator Bayh.

STATEMENT OF SENATOR EVAN BAYH

Senator BAYH. Thank you, Mr. Chairman, for holding this hearing on this important topic today, and I particularly want to thank you for your intention of having a follow-up hearing in 60 days. As you know, very often we have forums like this. We ask questions, we get promises and assurances, and then it kind of disappears into the void. So I think this is important enough that we stay focused on it, and I want to thank you for that.

I also want to thank our panel for being here today. I know you are all busy. You have important responsibilities, so we are grateful for your time and for your insights.

Mr. Chairman, I would particularly mention Mr. Dugan. His son, Jack, happens to be a classmate of my two boys, and so I assume he is a good Comptroller of the Currency, but I know he is a good father. And that is perhaps an even higher calling, so I just wanted to mention that today.

Very briefly, Mr. Chairman, I will follow up on something that Senator Reed mentioned, and that is the recent UBS estimate of additional write-downs, which, if true, could very easily lead to a contraction of lending, which would then lead to an even more sluggish economy, which can then drive unemployment up. It sort of becomes a self-fulfilling problem that we have.

So I agree with the comments that have been made that we have a short-term and a long-term challenge, and we need to try and reconcile these two to make sure that in solving today's problem we do not leave the bigger ones down the road. So we need to move aggressively to cauterize this wound, to stabilize the situation, but to do so in a way that does not lead to inflation down the road, does not lead to risks of moral hazard, weaker currency, these kinds of things.

So I am eagerly awaiting your testimony and your advice about how to strike the right balance, and having said all that, Mr. Chairman, we are here to listen to them, not to me, and again, I thank you for having the hearing.

Chairman DODD. Thank you very much.

Senator Hagel, any opening comments?

Senator HAGEL. No. Thank you, Mr. Chairman.

Chairman DODD. Senator Carper, any quick opening comments?

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. We welcome you. There has been an effort, as you probably know, to move a housing recovery package, and so far we have not been successful in doing that. But my hope is that under the leadership of Senator Dodd and Senator Shelby, we will have another bite at that apple in the next week or two or three. And when we do, our Republican friends will have an opportunity to offer amendments to that package, germane amendments, and we will have an opportunity on our side to offer some amendments as well.

When it comes time to ask questions, one of the things I will be doing with the panel is really suggesting some of the amendments that we have heard that our Republican friends are interested in offering to that package, asking your comments for or against, if you have some suggestions how we might improve, and some amendments that our side is interested in offering as well. So that would be, I think, helpful to us, particularly if we have a chance to get back to the floor and take this package up in earnest.

Thanks very much.

Chairman DODD. Thank you, Senator.

Senator Corker.

Senator CORKER. Mr. Chairman, thank you for the hearing. I am looking forward to hearing the panel and, therefore, will not have any opening comments.

Chairman DODD. Very good. I thank all of my colleagues.

Let me again welcome our witnesses here and thank all of you for taking the time to be with us.

Sheila, I do not know of a better introduction that could be given of you than the one that Senator Dole gave you here, so we maybe just want to leave it there. We are delighted to have you before the Committee again.

John Dugan is current Comptroller of the Currency and a welcome member anytime in this room, having sat in the chairs behind me here for some time. So we welcome you back to the Committee as the Comptroller of the Currency.

John Reich is the current Director of the Office of Thrift Supervision, and we thank you very much, John, for being with us.

JoAnn Johnson is the Chairman of the National Credit Union Administration, and we are pleased to have you with us.

Donald Kohn is, of course, the Vice Chair of the Federal Reserve, and we thank you very much for being here this morning as well.

And, last, Tom Gronstal, who is the Superintendent of the Iowa Division of Banking, is here on behalf of the Conference of State Bank Supervisors. You look like Mike. Are you related?

Mr. GRONSTAL. All Gronstals are related, and we are first cousins.

Chairman DODD. Mike Gronstal is the leader of the State Senate in Iowa. Why would I know that? [Laughter.]

Anyway, we are pleased to have all of you here with us this morning, and, Sheila, we will begin with you, and try and keep it to 5—you have all been here before. If you can try and keep it to 5 or 6 minutes—I do not wave a gavel around here, but—and let me also say to all of my colleagues and to the witnesses, all of your statements, the full statements, supporting data, material, graphs, charts, whatever else you want to add, will be included in the record. So whatever else you need to give us will be a part of this hearing.

Sheila.

STATEMENT OF SHEILA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Good morning, Chairman Dodd and Members of the Committee. Thank you for the opportunity to testify.

It is no surprise to anyone that the second half of 2007——

Chairman DODD. Would you check and make sure your button is on?

Ms. BAIR. It is no surprise to anyone that the second half of 2007 was a very tough period for the banking industry. Fourth quarter results were heavily influenced by a number of well-publicized write-downs by large banks. Weakness in the housing sector and a credit squeeze in financial markets made it a very challenging time for many institutions. We can expect these problems to continue throughout 2008.

Last week, we released our “Quarterly Banking Profile,” which analyzes financial results for the entire industry. It was a weak report. Industry earnings were down 27 percent for last year, and while in the black, they were the lowest we have seen since 2002. Fourth quarter results alone were the lowest we have seen since the early 1990s. Higher loan loss provisions, big losses on trading activities, and write-downs of goodwill were the main factors that dragged down industry earnings during the quarter.

A substantial part of the sharp decline in fourth quarter earnings was concentrated in a handful of institutions. Six large institutions accounted for more than half of the total decline. Fortunately, they all remain well capitalized. Many community banks are also having problems. They, too, are seeing their troubled loans increase and their earnings diminish, but less so than the large banks. Overall, slightly more than half of the 8,500 banks and thrifts that we insure reported lower fourth quarter earnings and have reported increases in troubled loans.

Despite a tough economic environment, however, the vast majority of institutions so far are successfully coping with the challenges they face. The industry as a whole is coming off a golden period of record profits. Because of this financial strength, banks and thrifts of all sizes are overwhelmingly very safe and very sound. Ninety-nine percent of insured institutions were well capitalized at the end of 2007, representing 99.7 percent of all bank assets. Nearly 90 percent were profitable for the year, and insured institutions increased regulatory capital by more than $29 billion during the fourth quarter to bolster their ability to absorb losses.

Nevertheless, we are well prepared should there be an uptick in bank failures. The Deposit Insurance Fund remains strong, with $52.4 billion, and we are beefing up the number of staff with experience in dealing with failed institutions. As for troubled banks, there are 76 on our problem list. This is a very small number by historical standards when you consider the nearly 1,500 troubled banks we had on the list in the early 1990s. And these are small banks, with only $22 billion in assets compared with $13 trillion in total industry assets.

As part of our efforts to stay ahead of the curve, our examiners are very focused on asset quality as write-offs and loss provisions are likely to remain high for the near future. We are focused not only on mortgages as the housing downturn continues, but also commercial real estate, credit card, and small business lending.

We have been worried about commercial real estate lending for a number of months now. We warned industry, along with other regulators, about rising concentrations of these loans, especially for construction and development, and issued guidance in December 2006. Given the weakness in housing markets around the country, we are keeping a very close eye on trends in the construction and development sector, particularly at banks with high concentrations.

We also remain concerned about the ongoing rise in foreclosures, especially for subprime borrowers. We continue to urge lenders to provide long-term, sustainable, and affordable mortgages. I am encouraged by the greater number of homeowners being helped, according to the Hope Now Alliance. I am also pleased that loan modifications as a percentage of total workouts rose in January. However, I do remain very concerned about the reliance on repayment plans. These may be unsustainable for borrowers and lead to delinquencies down the road and contribute to ongoing borrower distress. It is absolutely critical that borrowers have loans they can afford over the long term. I am hopeful that loan modifications will accelerate. But at the same time, I recognize that additional action might be needed to reduce foreclosures and prevent the housing market from overshooting as home prices adjust downward.

Longer term, I firmly believe that by returning to more traditional lending practices, we can better protect consumers and help our regulated banking industry regain market share in mortgage lending in the process. In addition, there is now widespread recognition of the importance of strong capital to protect banks in times of stress as well as the need for transparency to maintain liquidity in the structured finance market. We need to recognize the limitations of this risk-based modeling, and we need a commonsense approach for using credit ratings. In short, we need to get back to basics in both the primary and secondary mortgage markets. In the long run that will serve us all.

Thank you very much.

Chairman DODD. Thank you very much, Sheila.

John, welcome.

STATEMENT OF JOHN C. DUGAN, COMPTROLLER OF THE CURRENCY, U.S. TREASURY

Mr. DUGAN. Chairman Dodd and Members of the Committee, thank you very much. I am pleased to be here today to testify on the condition of the banking system. And, Senator Bayh, thank you for those very kind words.

In general, due to a long period of strong economic growth, exceptionally low credit losses, and strong capital ratios, the national banking system has been healthy and vibrant.

Now, however, the system is being tested. Two powerful and related forces are exerting real stress on banks of all sizes and in many different parts of the country. One is the large and unprecedented series of credit market disruptions, still unfolding, that was precipitated by declining house prices and severe problems with subprime mortgages. The other is the slowdown in the economy, which has begun to generate a noticeable decline in credit quality in a number of asset classes. The combination of these forces has strained the resources of many of the national banks that we regulate.

Despite these strains, the banking system remains fundamentally sound, in part because it entered this period of stress in such strong condition. Thus far national banks have been able to address a number of significant problems that have arisen while continuing to supply credit and other banking services to the U.S. economy—although there is no doubt that credit standards have tightened. For example, large banks provided liquidity support to asset-backed commercial paper conduits and structured investment vehicles, or SIVs, often involving the painful recognition of losses to restore more normal funding in these markets. Likewise, banks with concentrated positions in collateralized debt obligations backed by subprime asset-backed securities have recognized large losses, but have also raised large amounts of capital to offset these and other losses. And a large national bank holding company entered into an agreement to purchase the Nation's largest mortgage originator, which had been under severe funding stress, and that action had a calming effect on the market.

Despite such efforts, however, significant market disruption issues remain to be addressed, such as the potential downgrades of monoline insurance companies; significant funding problems in the auction rate securities market; and severe constriction in the securitization markets for residential mortgage-backed securities, commercial mortgage-backed securities, and leveraged loans.

Likewise, the economic slowdown and problems in the housing market have caused banks to increase loan loss reserves significantly for such assets as residential construction and development loans, home equity loans, and credit card loans. Indeed, smaller banks that have exceptionally large concentrations in commercial real estate loans—and there are many of them—face real challenges in those parts of the country where real estate markets have slowed significantly. Unlike the unprecedented market disruptions of the last 6 months, however, these more traditional credit problems are familiar territory to bankers and regulators. The key to addressing them is for bankers to recognize problems early and manage through them, and that is exactly what our examiners are working with them to do.

There is also a need to re-emphasize several fundamental banking principles: sound underwriting and robust credit administration practices; diversified funding sources and realistic contingency funding plans; strong internal controls and risk management systems, including stress-testing, valuations, and disclosures; and timely recognition of losses coupled with adequate loan loss reserves and strong capital cushions. In each of these four areas—asset quality, liquidity, risk management, and reserves and capital—we remain alert to emerging trends and to findings that may trigger additional supervisory action.

Finally, you asked us to describe our current efforts to address foreclosure prevention and mitigation. This is very important for the OCC since the nine largest national banks act as servicers for about 40 percent of all U.S. mortgages, including a significant number of subprime mortgages. The OCC has taken a number of steps to encourage national bank lenders and servicers to work constructively with borrowers to avoid foreclosures except when absolutely necessary. We have joined the other banking agencies in issuing guidance to that effect. We have strongly supported the efforts of the Hope Now Alliance, and we have supported an amendment to the Community Reinvestment Act regulations that would provide CRA credit for foreclosure prevention activities in distressed middle-income neighborhoods.

We also announced last week a significant new effort regarding the reporting of key data on mortgages, including mortgage modifications. We are requiring our largest national bank servicers to provide standardized reports on a range of mortgage metrics, not just for subprime adjustable rate mortgages but for all mortgages. These data, which are consistent with the Hope Now metrics, will provide an important way to track mortgage performance against a broad range of indicators.

Thank you very much.

Chairman DODD. Thank you very much.

Mr. Reich.

STATEMENT OF JOHN M. REICH, DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. REICH. Good morning, Chairman Dodd, Members of the Committee. Thank you for the opportunity to testify on behalf of the Office of Thrift Supervision. My written testimony contains fairly lengthy and detailed information, but in the few minutes I have here, I will highlight just a few points.

First, the condition of the Nation's savings associations. My testimony today will be no surprise. Thrift institutions like the entire financial services industry are facing serious challenges from the mortgage market crisis affecting the broader economy, and I believe that these challenges will persist throughout 2008 and into 2009.

During the fourth quarter of 2007, the thrift industry posted a record loss of $5.2 billion in the fourth quarter. Troubled assets continued to rise. For all of calendar year 2007, the industry posted a profit of $2.9 billion.

Although good news is scarce in the current landscape, I can tell you that the mortgage market's problems have created an earnings issue for thrift institutions, but not a capital issue, and I believe that is an important distinction. In addition to earnings, even reduced earnings, capital and loan loss reserves provide the foundation of support for financial institutions during times of challenge, and thrift institutions continue to maintain strong capital and continue to set aside significant loan loss reserves.

I can also report that the OTS is in a strong position to continue to carry out our mission of ensuring the safety and soundness of thrift institutions and their holding companies and of ensuring compliance with consumer protection laws. These laws include prohibitions against unfair or deceptive acts and practices, an area where OTS recently issued a proposed rulemaking.

Since I became OTS Director in 2005, we have increased our workforce by more than 15 percent, primarily among our examining force, and our budget is solid. Although the consolidation affecting the entire financial services industry has reduced the number of thrifts that we regulate to approximately 830, assets supervised by OTS have grown by 55 percent over the past 5 years to more than $1.5 trillion, and in the last 3 years, more financial institutions have converted to the thrift charter than have converted from the thrift charter. This is a noteworthy trend, I believe, which speaks to the value that the financial services industry sees in the thrift charter.

The last point I would like to make is that OTS understands the enormous impact that home foreclosures can have on Americans and the communities where they live. To contribute in a meaningful way to a solution to this growing problem, we recently suggested a foreclosure prevention proposal that we think merits discussion and debate to help financially stressed homeowners who owe more on their homes than they are currently worth. I have seen estimates that 30 percent of homeowners who have purchased their homes in the last 2 years are in this position of being upside down or underwater. Our plan would provide an incentive for homeowners in distress whose mortgages are underwater to stay in their homes instead of turning in their keys and walking away. It is a market-based proposal without the cost and potential moral hazard of a Federal bailout. It would also allow the lender or investor to share in the upside when the home again appreciates in value once this crisis subsides.

Under this proposal, the distressed homeowner whose loan was previously sold into a securitization would obtain new FHA financing based on the current market value of the home. The servicer would receive a partial payoff and would record a negative equity certificate equal to the difference between the new FHA loan and the currently outstanding loan balance. When the home is sold, the certificate owner would recover an amount potentially reaching the full value of the certificate, depending on future home price appreciation. Beyond that amount, appreciation would revert to the homeowner.

This proposal is certainly not the only idea to address the rising number of foreclosures, but we believe there is significant merit in considering this approach as a supplemental component to the efforts that are underway to deal with this crisis.

With that, Mr. Chairman, I thank you, and I look forward to questions.

Chairman DODD. Thanks very much, and thank you for that testimony.

Ms. Johnson.

STATEMENT OF JOANN M. JOHNSON, CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION

Ms. JOHNSON. Thank you, Mr. Chairman and Members of the Committee, for this opportunity to testify regarding the state of the credit union industry in the context of your broader review of how financial institutions are performing during the recent turbulence. This is a timely and important subject that merits congressional oversight. NCUA provides oversight and supervision for 8,100 federally insured credit unions, serving approximately 87 million members.

The financial state of the credit union industry remains strong and healthy with financial trends indicating a safe and sound industry. I will outline key data which supports this conclusion and also underscores NCUA's belief that the industry has implemented our regulatory guidance regarding the need for increased vigilance and more careful management of credit union balance sheets. federally insured credit unions are well capitalized. Net worth stands at 11.4 percent, and over 99 percent were at least adequately capitalized. Total assets are at $753 billion, and aggregate net worth is $86 billion, the highest dollar amount in history.

Lending continues to be a main focus of credit union service to members. As of the end of 2007, loans represented almost 70 percent of credit union assets. Within that figure, real estate loans comprised just over 51 percent of total loans.

Credit union mortgage lending is primarily of the traditional variety: 58 percent of mortgages are fixed-rate, and only 2.3 percent are interest-only or optional payment loans that have garnered much of the recent attention on Capitol Hill and made this hearing, unfortunately, necessary.

After several years of declines, delinquencies and losses have increased. Overall, loan delinquencies have increased from 0.68 percent to 0.93 percent, and real estate delinquencies now stand at 0.68 percent. Net charge-offs are 0.08 percent.

Those relatively low numbers indicate that credit unions have positioned themselves to withstand the current economic uncertainty and related mortgage problems. To make certain that continues, NCUA has played a proactive and aggressive role in issuing supervisory guidance regarding lending. Since 1995, NCUA has issued guidance on risk-based lending and specific mortgage lending guidance that has identified potential problem areas, particularly regarding subprime lending, credit risk management, due diligence, and stringent evaluation of third-party relationships.

Home equity lines of credit, or HELOCs, and so-called exotic mortgage products such as interest-only and payment-optional, were also covered by this guidance. As in the past, and most recently in concert with my fellow regulators, joint guidance regarding workout arrangements, subprime lending, and loss mitigation was issued.

All of this was aimed at increasing credit union awareness of the potential pitfalls inherent in a rapidly changing and complex lending landscape. It also served as a constant reminder to the industry of NCUA's vigilant posture when it comes to identifying and managing risk. While NCUA appreciates the desire of credit unions to serve their members as fully as possible, we recognize that there is no substitute for strong supervision that enhances safe and sound operations.

Federally insured credit unions remain financially strong. They have implemented NCUA guidance related to real estate and other lending and, as a result, are positioned to weather the current economic turbulence. While data shows that the industry is not entirely insulated from the adverse impact of the mortgage situation, it also supports the conclusion that strong risk management and prudent standards, closely supervised by an engaged regulator, will ensure continued success.

Thank you very much for the opportunity.

Chairman DODD. Thank you very much, Ms. Johnson.

Mr. Kohn.

STATEMENT OF DONALD L. KOHN, VICE CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. KOHN. Thank you, Mr. Chairman. Chairman Dodd, Members of the Committee, I appreciate the opportunity to appear before you today.

As you know the Federal Reserve has supervisory and regulatory authority over a wide range of financial institutions and activities, including supervision of bank holding companies and state-member banks, as well as responsibility to ensure fair and equitable treatment of consumers in their financial transactions. And all these are important components of our broader mandate to help maintain overall stability in financial markets.

The U.S. banking system is facing some challenges, but remains in sound overall condition, having entered the period of recent financial turmoil with solid capital and strong earnings. The problems in the mortgage and housing markets have been highly unusual, and clearly some banking organizations have managed their exposures poorly, suffering losses as a result. But in general these losses should not threaten their viability. We, along with the other banking agencies, have been working with banking organizations to identify and rectify shortcomings in risk management that have led to losses and to ensure that the banking system continues to be safe and sound.

Our efforts also include helping to minimize any excessive financial impact on those consumers affected by recent market disturbances. Bank holding companies have seen their profitability decline in recent months due to sizable write-downs and substantially higher provisions for loan losses.

Liquidity has also been under pressure at some of the largest bank holding companies, in some cases reflecting difficulties securitizing some assets and the need to bring on balance sheet some assets that had been previously securitized. In some cases, asset write-downs and unplanned increases in assets have placed pressure on capital ratios and caused some banking organizations to take a more cautious approach to extending credit.

State-member banks are facing similar challenges, but also entered the recent period of financial disturbance in sound condition.

In this environment, we have been focusing supervisory efforts on those institutions most exposed to residential and commercial real estate and other sectors that have come under pressure. We are also attentive to those institutions that would suffer most from a prolonged period of deterioration in economic conditions. Our attention remains on the financial condition of the banking organizations, including the adequacy of the liquidity capital loan loss reserves and their consequent ability to cope with additional losses.

We are also evaluating risk management practices closely, including scrutinizing governance and controls, given some of the risk management lapses in those areas.

Supervisors will be looking at the capacity of a firm as a whole to manage all its risks and to integrate risk assessments into the overall decisionmaking by senior management. Additional emphasis on enhancing stress-testing is also appropriate to focus more bank attention on risks that have a low probability of occurrence but severe potential costs.

Particular areas of supervisory focus include residential mortgage lending, consumer protection, bank liquidity and capital positions, consumer non-mortgage lending, commercial real estate, and commercial lending. While residential mortgage lending has, unfortunately, presented substantial problems for many homeowners and communities, it has also created challenges for banking organizations. Accordingly, it is receiving much supervisory attention.

For example, the Federal Reserve and other banking agencies have encouraged mortgage lenders and mortgage servicers to pursue prudent loan workouts to assist borrowers having difficulty meeting their payment obligations through such measures as modification of loans, deferral of payments, extension of loan maturities, capitalization of delinquent amounts, conversion of ARMs into fixed-rate mortgages or fully indexed, fully amortizing ARMs.

Our reserve banks are working closely with local community groups to identify opportunities for workouts and to educate both borrowers and lenders. We are also carefully monitoring those areas that are most likely to be adversely affected by residential real estate, such as construction loans and non-mortgage consumer lending, and taking appropriate action. We have implemented supervisory strategies to ensure that we have the proper examination staff assessing commercial real estate, ready to address banking problems.

Finally, as part of a responsible and proactive supervisory approach, and as we have done in the past, we are conducting critical assessments of our own supervisory programs, policies, and practices. This is a prudent step and is consistent with longstanding Federal Reserve practice. Our intent is to identify opportunities for improving our own processes both within the current environment and as preparation for future supervisory challenges.

It will take some time for the banking industry to work through this current set of challenges and for financial markets to recover from recent strains. The Federal Reserve will continue to work with other U.S. banking agencies and the Congress to help ensure that bank safety and soundness is maintained.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Mr. Kohn, for that testimony. It was very helpful.

Mr. Gronstal, welcome.

STATEMENT OF THOMAS B. GRONSTAL, IOWA SUPERINTENDENT OF BANKING, STATE OF IOWA

Mr. GRONSTAL. Thank you. Good morning, Chairman Dodd and distinguished Members of the Committee. As Iowa Superintendent of Banking, I am pleased to testify today on behalf of CSBS on the condition of the Nation's banking industry, and specifically the challenges facing the State banking system.

The collapse of the housing finance market has resulted in the collapse of investor confidence in bond ratings, bond insurers, collateral valuation of asset-backed securities, and the impact has spread to trust preferred securities issued by banks, auction rate certifications issued by student loan secondary markets, and a general depreciation of asset-backed securities held in banks' portfolios.

A few lessons the State regulators would highlight from this experience are: one, that good underwriting is consumer protection; two, consumer protection is investor protection; and, three, transparency is in the interest of all parties. We believe these lessons should be applied to policies ranging from the preemption of State consumer protection laws all the way to Basel II. Also, as other witnesses have testified, the slowdown in the economy is beginning to reveal weaknesses in the commercial real estate sector. We will continue to work with our Federal counterparts to supervise the industry performance in this sector.

As I highlight in my written testimony, State regulators are prepared to handle a greater number of bank failures than we have had to in the last several years. But based on current information and conditions, we do not expect widespread failures. Obviously, a significant change in the economy could change that outlook.

I would note that while a manageable number of bank failures has a limited impact on the national economy, any bank failure is very disruptive to the local economy and the consumers in our communities and States.

Two additional areas where we think problems could arise are reverse mortgages and agricultural lending. Reverse mortgages are ripe for consumer abuse and fraud and could present some long-term accounting and valuation issues. CSBS has developed a seminar to help State mortgage examiners learn about the fast developing reverse mortgage market. Currently, the ag sector is experiencing a combination of high oil and commodity prices, similar to the conditions of the 1970s. The value of farmland is directly correlated to the price of commodities. We could be witnessing the development of a bubble in agricultural real estate.

The problems we are currently experiencing in the banking industry were triggered by the weakening of the housing market and the ensuing credit crunch.

CSBS contends that an enhanced regulatory regime for the mortgage industry is absolutely necessary to ensure legitimate lending practices, provide adequate consumer protections, and to once again instill both consumer and investor confidence in the housing market.

To that end, CSBS and ARMR launched the nationwide mortgage licensing system. The system is more than a database. It serves as the foundation of modern mortgage regulation by providing transparency for regulators, industry, investors, and consumers. While much has been done recently by Federal and State regulators to enhance supervision of the residential mortgage industry, State officials have also been very active in addressing the increasing foreclosures.

In July 2007, the State Foreclosure Prevention Working Group, composed of Attorneys General and bank regulators from 11 States and CSBS, was formed to work with participants in the subprime mortgage industry so borrowers could retain their homes with affordable mortgages. Beginning in November, the working group collaborated with the industry, the FDIC, and the Federal Reserve to develop a uniform data reporting format to measure the extent of the foreclosure problem and the servicers' efforts to respond. Last month, the working group issued the "Analysis of Subprime Mortgage Servicing Performance" report. It is my sense that many servicers are making positive efforts, but that we are still losing the larger battle to stem the tide of unnecessary foreclosures. More must be done to assist those Americans who are fighting to save their homes.

CSBS looks forward to continuing to work with the Federal regulators and Congress to address the needs and the regulatory demands of an ever evolving financial system fostering the strongest economy possible while protecting consumers, minimizing regulatory burden, and ensuring access to the broadest range of financial opportunity.

Thank you for the opportunity to testify today, and I look forward to any questions you may have.

Chairman DODD. Well, thank you very, very much, and let me thank all of our witnesses. I appreciate your brevity as well in allowing us to get to the questions here this morning.

What I will do is I will turn the clocks on here for about—let me see, not too many of us here—7 or 8 minutes so we get a decent amount of time for the first round of questioning. There are a lot of issues to be raised.

Obviously, as Senator Bennett pointed out, there is a fundamental question sort of raised this morning by the Wall Street Journal that will probably be a subject of all of our questions to one degree or another. But let me, if I can, begin by talking about Basel II, because this is a big issue. It is the center of a lot of attention in various articles here.

The current problems in the market highlight, I think, the critical importance of adequate capital standards for banks. That is the core issue in many, many ways—although not the only one. I think the risk management as well, and there are other questions here, but obviously the core element of having adequate capital standards is fundamental. And with the upcoming implementation of Basel II—and I gather, and those of you deeply involved in this can correct me, but I gather just in terms of how fast this is moving that while I think there was some talk about spring, it is probably a greater likelihood it is probably more in the fall before they will begin to move. So we have got a little time here to look at this and respond to it, if we can.

There is a potential for some major changes in the capital requirements that banks will face. There have been some concerns raised that the structure of Basel II would lead to some serious problems—I think you have all heard this—especially in the current environment we are in. Specifically, there have been concerns raised about the reliance of Basel II on internal bank models of risk, models which failed during the recent crisis that we have experienced in the market. A recent piece written here by Harold Benink and George Kaufman in last week's Financial Times reveals—the headline, "Turmoil reveals the inadequacy of Basel II." And let me quote from the article. It says, "A more fundamental problem is that Basel II creates perverse incentives to underestimate credit risk because the banks are allowed to use their own models for assessing risk and determining the amount of regulatory capital. They may be tempted to be overoptimistic about their risk exposure in order to minimize required regulatory capital and to maximize return on equity."

I would like each of you to respond to that concern, if you would, and then a follow-up question with regard to it is whether Basel II, if it had been in effect—let's move the calendar in the opposite direction. Let's assume it had been in effect in the last couple of years. What impact would Basel II, as proposed, have been on the current situation in your views? Would we be looking at a better or a worse situation if Basel II were in place? And, again, as background here, we obviously know what happened at this recent financial institution in England here where you had it was able—this one bank said it was able—"enabled them to increase our 2007 interim dividend by 30 percent." You may have all read this report. "And going forward, our dividend pay amount rate increases to 50 percent of underlying EPS from around 40 percent. Future capital planning, including reduction of capital assets, will allow us to return capital to shareholders through a share buyback program. The medium-term outlook for the company is very positive." That was Adam Applegarth, the Northern Rock Bank on June 30th of last year, and as all of you know, shortly afterwards they became insolvent, were nationalized, had the largest run since 1866.

So despite the positive predictions here under Basel II, I am very interested in how each of you would respond to the question. What would our situation look like today had Basel II been in place? Then, of course, responding, if you can, to the concerns raised by Mr. Benink and Mr. Kaufman. Sheila, we will begin with you.

Ms. BAIR. The FDIC institutionally has had longstanding questions and concerns about the use of internal models to derive capital under Basel II, and my personal view is that we are taking a very go-slow approach in implementation so we will have plenty of time to make adjustments as we try to look through some of those issues.

The problem with model-driven capital is that it relies on past performance, and when you have new higher-risk products that were developed and performed during a very favorable economic environment, your past performance is not going to tell you how they are truly going to perform when our economic circumstances change. And that is exactly what we saw with mortgages.

Our QIS impact study, the QIS, the Quantitative Impact Study——

Chairman DODD. Shouldn't that be a part of it? I mean, if past performance has been sort of rosy, shouldn't you be anticipating these matters here if things do not go well, as well as if things are going well?

Ms. BAIR. You should absolutely stress test. But, again, models are only as good as the data you put into them, and these models rely on historical data. That is one of the issues we have had.

The Quantitative Impact Study showed that there would have been a 73-percent median reduction risk-based capital for residential mortgage lending, and for home equity lending it would have been 79 percent. And, again, that was because there was benign historical data being fed into the models when the QIS studies were done.

So I think it would have put us in worse shape, and I think not only would we have had lower capital going into this, but I think we would have had banks—banks already having to raise capital—that would have had to raise it a lot more. So you have a pro-cyclicality with these reduced capital levels using models for benign economic times that spike up sharply.

So we think this has always been a crucial issue, a critical issue with the Basel II advanced approaches. I think there are many good elements of Basel II, also. I think it is important that there are other aspects of it that are positive. We will also go out for comment on the Basel II Standardized Approach, which does not use internal models but has more of a bucket system where for each asset category you have hard and fast floors under each bucket. And, of course, nobody is talking at this point about getting rid of the leverage ratio, which would be our fail-safe under all these new frameworks.

Chairman DODD. Well, I should have said—and I want to get to my question quickly. I do not want anyone here to walk out of this room with the assumption that the Chairman of this Committee is hostile to Basel II. I think there are some very, very positive elements of Basel II. The question is: Are we rushing ahead a little too fast without thinking about these other implications?

So I have a positive attitude about Basel II. I am just concerned about how some of this may work.

John.

Mr. DUGAN. Mr. Chairman, as I do on some of these issues with my colleague, I have a little different take on this. No. 1, the losses that we have really seen happened in the Basel I world, not a Basel II world, which is not directly responsive to your question.

I think on the Basel II question, there are some things that I think it clearly would have done better and will do better. I think it factors more risk management processes into the capital framework, and that is a good thing. I think it does a better job with not creating incentives between off-balance-sheet and on-balance-sheet risk. They are treated more equally under that program.

And with respect to the notion of dealing with historical data, while that is an issue with respect to Basel II, it was more of an issue when we only had benign data going into it because of all the benign credit issues that had gone on. We have taken care of that problem. There are a lot of losses now, that would be fed into the system. It is taken into account in how the data adjusts to those actual events and causes more capital to be raised. I think it is quite an open question, given the current events, whether capital in the system would go up, not down, as a result of what has happened.

But having said all of that, I think there are some very specific things that happened that really need a look in the Basel II process, particularly with these ABS CDOs that were based by subprime-related securities. Senator Bennett referred earlier to the credit ratings. The irony of this whole situation is that the most highly rated securities, the ones that were thought to be least likely to default, are where a huge share of the losses have been concentrated. And the securities with the highest rating get the least attention from management, from regulators, and from our capital regime. The fact of the matter is the AAA in this context performed much differently, and much worse, than AAA in any other type of security we have ever witnessed before. There has to be a need to look at that, and one of the places we need to look at it is whether the Basel II capital risk weights for this particular kind of security need to be adjusted. I think that is extremely important going forward, along with some other measures.

The last point I will make is, although the rule is final, it is quite a deliberate pace that is going on in the United States. Firms have 3 years to begin the first parallel year of running, which is not actually the year you get on it. There is another year, and then there is a 3-year transition period. No firm has actually even started that: the first firm may begin this summer. I think it will be staggered over time, and meanwhile we do have these systems of floors in place to fine-tune things as we go along. But you are raising very good questions that need to be looked at and adjusted as we go forward.

Chairman DODD. John or JoAnn, do you have any comments on this? I want to hear the Fed's point of view on this, but I want to also hear if you have any thoughts on this. Yes, go ahead.

Ms. JOHNSON. I would like to add just a point. While credit unions do not fall under Basel, we do have a risk-based capital proposal on the table for Congress to take a look at it, and I would ask your serious consideration because this would give us as a regulator a real tool to identify problems more quickly, and it would help the credit unions manage their risk more effectively. And it is our risk-based capital, prompt correct action proposal. We have been working for over 3½ years on it, but we need legislative action in order to get it done.

So I would just please ask for your serious consideration. It would really give us a tool as a regulator.

Chairman DODD. John, do you want to comment?

Mr. REICH. Mr. Chairman, I would like to make a comment. I began my banking career about 47 years ago, and I grew up in a generation of bankers who believed that you cannot have too much capital and you cannot have too much money in your loan loss reserves. I still believe that today.

When I entered the Basel discussion as a banking regulator about 2½ years ago, I was a skeptic about Basel II. I am still sort of skeptical today, but I feel a lot more comfortable today about it than I did 2½ years ago, and one of the reasons is that I have been talking with my fellow regulators at this table about Basel II over the past 2½ years, and I know that there is one thing that we are all committed to, and I believe that every single individual is committed to making whatever changes need to be made between now and full implementation in 2012.

We also have the authority, which is not discussed a great deal, in Pillar 2 of Basel II for the regulators to have the latitude and the flexibility to require whatever additional levels of capital we think are necessary over and above what the models predict. So we are not totally dependent on the models. Our examiners in the field and their supervisors in our regional offices will be reviewing capital, will be reviewing the risk profiles of these institutions. And if we feel they need more capital over and above what the models call for, we will call for that additional capital.

Chairman DODD. Let me just, Mr. Kohn, in asking you to respond to this, let me pick up on something that John Dugan said that I will just take a little issue with. John mentioned about how this was all operating under Basel I. Well, that is true in this country. It was not true in Europe. Europe was operating under Basel II. And the quote I had from that British bank here was under Basel II regulations.

Again, I am a supporter of Basel—this thing moving forward, but it seems to me here that looking at what has occurred here under a regime that we are talking about adopting here raises some questions. And why shouldn't I be concerned about Basel II, having watched what happened in Europe and why that couldn't be here, and why it would be worse if, in fact, Basel II had been in place over the last several years?

Mr. KOHN. Mr. Chairman, I think they are implementing Basel II this year in Europe, not last year, so——

Chairman DODD. Wasn't this effective—wasn't that British bank under those rules? Am I wrong about that?

Mr. DUGAN. It had the parallel running year, but the final——

Chairman DODD. The parallel year——

Ms. BAIR. They had approved the reductions that were referenced, and they were promising a dividend based on the reduction—the anticipated reduction risk-rated assets, which had been approved.

Mr. KOHN. And I think to pick up on a point that John Dugan made, some of the issues in Europe and to some lesser extent in the United States involved capital arbitrage, moving things off of balance sheets because it was less capital-intensive to do that. And one of the things that Basel II does is it tries to even that out. It tries to reduce the capital incentive to move something off your balance sheet. And I think moving it off the balance sheet clearly gave banks a sense that they did not need to manage that risk as intensely as they would have if it was directly on their balance sheet, and a lot of that stuff ended up coming back onto their balance sheet.

So I think from some very important perspectives, Basel II actually addresses some of the issues that have come to light in the most recent turmoil. That is not to say it is perfect. It is a huge step in the right direction, and I appreciate, Mr. Chairman, your support for this basic structure because I think it is an important step forward to make the capital requirements more risk sensitive so there is less of this arbitrage opportunities for banks.

John pointed out one in the securitization area. It is heavy reliance on the credit rating agencies. I think we need to take a look at that and how close that reliance is. But there are a lot of safeguards here. There is the Pillar 2 safeguard. The banks cannot implement these models before the supervisors have looked at them and given their OK that these are good models.

There is the phase-ins that Sheila and John talked about. There will be a year of parallel running. Then there will be a 3-year phase-in, and changes can be made at any time. And John Reich is absolutely right. The regulators are committed to make this work for a safe and sound U.S. banking system. We will have a period of years to watch how the implementation is occurring and to make adjustments if necessary.

So I think it is important to move forward, recognizing the issues and keep a careful eye on how it is working out. But I think at the end, we will have a better capital system in 4 years than we had last year.

Chairman DODD. And I hesitate to ask anyone at the Fed a simple yes or no question, knowing your resistance to those kind of answers. [Laughter.]

But would we have been better off or worse off had Basel II been in place under the recent crisis?

Mr. KOHN. The honest answer is I do not know. I think in many respects—in some respects we would have been better off, and I do not think we would have been worse off if the whole implementation process had been moved back 2 or 3 years, so we had the same safeguards in place, and if we started implementing in 2004 with the same safeguards that are in place in 2008 and 2009, I do think on balance we would have been better off.

Chairman DODD. Do you have any comments on this, Tom? I have taken a lot of time on this question.

Mr. GRONSTAL. Thank you. I think the answer to your second question is that we probably would have had lower dollar amounts of capital per asset, and that makes it more challenging to deal with issues when times get rough. Being a banker in the 1980s out on the prairie in Iowa, there is no substitute for capital when things get rough.

So I think we would agree that we do not want to see capital standards reduced, and we want to make sure that as Basel II is implemented that it provides an opportunity for regulators to make sure that we can require institutions to have adequate capital at all times.

Chairman DODD. Well, thank you very much. I took a long time—I apologize—going through that. I took a lot more than 8 or 10 minutes. I should have realized with this many witnesses that was naive of me to assume I could do that.

Richard, do you want to jump in here?

Senator SHELBY. I will, briefly. I know I have not—I have been gone. Thank you, and I welcome all of you. I will get right to a question.

Comptroller Dugan, are you confident that banks have not outsourced their due diligence and risk analysis to credit rating agencies? And is that a problem? It seems to be a concern to a lot of people?

Mr. DUGAN. Senator, it did not take long for you to get right to the heart of the matter, as always. I do think there is an issue with credit rating agencies. I have spoken on this recently. I would not go so far as to say that banks have outsourced it lock, stock, and barrel. But I think that in the recent round we have seen the very high credit ratings for a certain class of securities, these collateralized debt obligations, based on subprime asset-backed securities which were not only rated AAA but were considered senior to AAA securities. I think there was an undue reliance generally on that rating, and even with some of the most sophisticated banks, as they packaged these, there was an undue reliance on the credit ratings. That should not happen, particularly with larger institutions that have the wherewithal and are in the business of making credit assessments. I think this is one of the fundamental lessons that has come out of this that we will be going back to our banks quite forcefully on.

Senator SHELBY. You are going to have to, aren't you?

Mr. DUGAN. Yes.

Senator SHELBY. Chairman Bair, it is my understanding that you currently have 76 institutions on the FDIC's problem list. In addition, there appear to be strong indications that further deterioration is occurring outside of mortgage lending, specifically in the construction lending, tied to new homebuilding and home equity lending.

In your written testimony, you suggest several differences between this down cycle in the housing market and the period in the early 1990s. I believe you suggested the biggest differences between then and now is capital, which Senator Dodd, Chairman Dodd, was asking earlier. Even though banks are better capitalized, do you expect to see a gradual increase in the number of troubled financial institutions?

Ms. BAIR. Well, it is hard to predict the future, but certainly credit losses are going to continue to tick up, and so my guess is that we would see some increase in the troubled bank list. But I think we will still be easily within historical norms. I do not think it will be anything we cannot handle. Historically, banks fail. They used to fail a lot more than the numbers now.

Senator SHELBY. And this cycle will be no different, will it?

Ms. BAIR. No, it will not be. We went 2½ years without a bank failure. That was aberrational, frankly. It is common for a small number of banks to fail each year. The FDIC has a very good record. No insured depositors ever lost a penny of insured deposits. We almost always find another institution to acquire the insured deposits, so there is virtually no interruption in access to the money.

So people should not worry. This is easily within historical norms.

Senator SHELBY. I know you cannot put a number on it, but would it be out of the question to say that it is possible 100 banks would fail? You do not want to do that?

Ms. BAIR. I would think that would be surprising. We have 76——

Senator SHELBY. There are 76 on the——

Ms. BAIR. Most of those will not fail. The historical average is——

Senator SHELBY. You will work around it.

Ms. BAIR [continuing]. 13 percent of those on the troubled bank list actually fail, which is a very small percentage. So it would be very, very surprising if we saw numbers at that level.

Senator SHELBY. How do you feel about the adequacy of the FDIC fund, and what size is it currently?

Ms. BAIR. We are at $52.4 billion. Our reserve ratio is 1.22 percent. We have got an assessment of 5 to 7 basis points on insured deposits which will bring us to our target ratio of 1.25 next year.

So I am feeling we have a strong fund. It is a highly liquid fund. We have strong staff resources. We have strong contingency plans to be prepared for any eventuality. So I think that we have very good resources and are very in strong shape, and people really should not worry.

Senator SHELBY. Governor Kohn, do you believe that our money center banks, some of our largest banks that the Fed supervises through the bank holding company, will have to have a lot more capital than some have been getting additional capital?

Mr. KOHN. Senator, I do not think that the level of capital that they currently have is inadequate to safeguard their fundamental safety and soundness. But I do think that there are a couple that——

Senator SHELBY. You say inadequate or adequate?

Mr. KOHN. The level of capital that they have is adequate.

Senator SHELBY. Adequate, OK.

Mr. KOHN. To be clear, to safeguard their fundamental safety and soundness. They are not threatened in that regard. I do think that raising capital will enable them to participate in the rebound, will enable them to be more active lenders as the economy recovers. So there are some whose activities would be constrained if they do not raise more capital. Their viability is not threatened, but they will be smaller institutions than if they raise capital.

Senator SHELBY. Do you have some of your larger holding companies on so-called watch lists? I know you watch them all. You have to say.

Mr. KOHN. It is fair to say we do watch them all, and we are actively engaged in conversations with all of them about how they see their way forward.

Senator SHELBY. Are you deeply concerned about any or maybe concerned about a few?

Mr. KOHN. We are talking to all of them, Senator.

Senator SHELBY. OK. Thank you, Senator Dodd.

Chairman DODD. Thank you very much.

Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman, and thank you, ladies and gentlemen, for your stewardship and your dedication. I appreciate it very much.

Let me selectively ask a common question, which—starting with Sheila Bair. Capital levels, liquidity, and dividend policy of your regulated institutions. Capital, is it adequate? Is there sufficient liquidity, or do you see a problem in that regard? And what about dividends policy in the sense that if there is a real push to ride out hard times, should banks be giving dividends at the rate they are? And then I will go to Mr. Dugan, then Mr. Kohn.

Ms. BAIR. Ninty-nine percent of our banks are well capitalized. That represents 99.7 percent of bank assets. So the overwhelming majority of banks, large and small, are well capitalized. We have about $270 billion in excess capital. That is an additional cushion that we can rely on. So, yes, I think banks are in a very, very strong capital position.

Regarding liquidity, we are fortunate in the United States to have multiple funding sources. Deposits is one. The capital market is not as robust as it once was. But we have the Federal Home Loan Bank System that helps support mortgage lending through a variety of funding mechanisms that can be used. We require, as do the other primary regulators, to have contingency liquidity planning, and I think that works pretty well.

We are in more challenging times, but I think we are taking the supervisory steps that we need to take, and the very strong capital levels I think will serve us well.

I am sorry. What was the third——

Senator REED. The third one is dividend policy. Are you reviewing dividends, the dividends——

Ms. BAIR. Dividend policy, well, I think it is important—I was a little surprised at the level of dividends last year, but I think certainly that is one easy area to cut back on. So, again, if we get into a more challenging environment——

Senator REED. And let me inject one other factor. We are looking today at the climate, but the estimates that we are seeing—the UBS one I mentioned in my opening statement of a $600 billion write-down. I mean, capital is adequate today. Is it adequate in that sort of Category 5 hurricane effect?

Ms. BAIR. Yes. I think banks are raising additional capital. They will continue to do so. I think it is important to point out the UBS estimates relate to all financial institutions.

Senator REED. Across the world.

Ms. BAIR. A lot of these exposures are outside the insured depository institutions, so I think that is a much smaller exposure for assets actually held in the bank in terms of the structured finance products that they were talking about.

Senator REED. Mr. Dugan, same series of questions.

Mr. DUGAN. I agree with Sheila with respect to our national banks, which are some of the very largest banks, as well as some of the smallest banks, that capital is indeed adequate. We did have some issues that were more than earnings events that hit capital, but banks were able to successfully raise capital to more than offset those losses. There is a chart in my testimony that talks about that. That is a good thing because it means that the market is still prepared to invest in the basic business model of U.S. banks.

Second, having said that, I will say you raise a very good question. As things change, there may be needs for more capital, and I think it is important that banks be ready to raise more, not just for today, but to prepare for additional things that are happening. As Governor Kohn mentioned, if banks want to be more forward leaning in participating in the rebound, they are going to have to have some extra capital.

Senator REED. And just that the alternative to raising capital—because there might be costs to doing that—is you shrink basically your lending activities and your——

Mr. DUGAN. Precisely. That is the part of the tradeoff that we worry about. I am going to take it a little out of order because I want to talk about dividends second because it is related to capital. You are right that there are a lot of dividends being paid out, and if you retained them, you would have more capital. But there is a tradeoff there. The fact is banks have been very good and very able to go and raise capital, in part because they pay dividends. And if you were to cut all the dividends, you would not so easily be able to raise capital in the markets. There is that tradeoff that goes on.

I think several institutions, including some large ones, have made the judgment that it is prudent to cut dividend levels, not completely but some in order to husband more capital. We think that is perfectly appropriate and prudent given——

Senator REED. Do you engage in that dialog, Mr. Dugan?

Mr. DUGAN. Yes, we do engage in a dialog.

Last, on liquidity, I would say the same thing as Sheila, that given all that happened and the tremendous stresses in market liquidity in particular, commercial banks fared actually pretty well because of their diversified funding sources and deposits. You mentioned the Northern Rock situation earlier. One of the reasons they had such problems is their whole business model was built on the securitization markets. I think banks had pretty good contingency liquidity plans. We spent a lot of time on that. Could they have used some more liquidity given the depth of this thing? Yes. Does that mean we need to look harder at this and update some of the liquidity things we are doing? Absolutely.

Senator REED. Let me jump to Governor Kohn now, the same series of questions, but you have a much more challenging responsibility because you have not just a bank in your portfolio, you have an investment desk and trading desk and the modern bank holding companies. So the same series of questions: capital, liquidity, and dividend policy.

Mr. KOHN. OK. I agree with the comments of my colleagues. I think our institutions are well capitalized, but as I noted to Senator Shelby, I think they need to pay attention to the possibility of raising more capital to protect against downside risks and to take advantage of the opportunities that are there.

I would say on dividend policy, looking at your dividend policy ought to be an essential component of looking at all the sources of capital and which sources you think will serve your bank holding company best over long periods of time. So I think dividend policies definitely should be on the table, as they have been for a number of institutions already.

With regard to liquidity, liquidity was adequate, but it was strained from time to time. And it was not so much that the banks could not get liquidity, but the degree of stress on the banks was so great and so much greater than they anticipated that they started hoarding it and were unwilling to lend it in the market. So we saw pressures in term funding markets. Banks were holding onto the liquidity, unwilling to lend for a month, 2 months, 3 months. And that was disruptive to the markets.

So I think two points: one is the banks themselves need to do a better job of preparing for some of these worst-case outcomes in terms of stress tests and where liquidity is going to be so that they are better prepared for such a situation. But the other point is the Federal Reserve, seeing this strain and this stress, itself took actions to relieve it, to make the Federal Reserve a more open source of liquidity for banks. We reduced the penalty on our discount rate from a percentage point to 50 basis points in August, and we started a new auction facility where banks could borrow money from the Federal Reserve against a wide range of collateral. We started this in December, and that has been pretty successful. Banks have taken advantage of this, and I think it has helped to relieve some of the tensions in funding markets. But it required actions, I think, both on the part of the banks and on the part of the central banks to relieve the pressure on liquidity.

Senator REED. Thank you. My time has expired, Mr. Chairman. If you will indulge me for one other question, this goes back to the line of questioning that the Chairman raised about Basel II. Very briefly, since I am imposing on my colleagues, if there is not fundamental reform of the credit rating agencies, is it sensible to move forward to Basel II since the credit rating agencies—and I am simplifying this greatly—and self-policing by the banks are the two elements, significant elements of Basel II? Unless we fix the credit rating agencies, are we inviting another problem? And I say that knowing that it is the SEC's responsibility, not your responsibility. Sheila.

Ms. BAIR. Well, I think we do rely far to much on external ratings, at least for structured finance products. And in the corporate debt market, there is enough transparency in the information about the underlying asset quality that it is OK.

We have suggested—and we will have a question along these lines, I believe, when we go out for comment on the standardized approach as to whether use of a rating, at least for structured finance, should be conditioned on the availability of information about the underlying assets or whether we should affirmatively require banks to get that information to do their own independent analysis.

So I think we are so heavily reliant on ratings that to just stop I think would be very difficult. But we have been thinking in terms of requiring additional transparency and analysis before you could use the rating, which I think would help provide some greater discipline on the rating process.

Senator REED. Anyone else? John.

Mr. DUGAN. I believe the rating agencies are doing some fundamental things to look at how they rate structured credit, particularly asset-based securities structured credit, and there are things that we can do as regulators, regardless of how they rate those things, to regulate how our institutions treat those rated securities as a matter of capital and so forth.

I think it should not stop us from moving forward with Basel II, but there do need to be some changes made.

Senator REED. And Mr. Kohn.

Mr. KOHN. I think the credit rating agencies do need to be more transparent about how they rate and the underlying assets that they are rating so that people who are using their ratings can look through the ratings to the underlying assets. And they are moving in that direction, but I think there is a lot of progress that needs to be made. And I think this issue of the structured finance is very important. A corporate bond with a AAA rating will behave very differently in the market than a piece of structured finance with a AAA rating. And people need to understand that. They cannot rely just on the AAA rating. And I think the credit rating agencies need to consider very carefully and probably move toward supplementing one rating that just is the probability of default, which is the AAA, with another rating, which says something about how the structured finance might behave under various market conditions, because it is a very different instrument than the ordinary corporate bond, and people need to understand that.

Senator REED. Thank you.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Jack, very much. There are some related issues, by the way, on the credit rating agencies. I appreciate Jack bringing it up again on this, the parallelism in terms of how various instruments are rated. There have been some articles written about that that are worthy, and I am going to take advantage, again, just to the issue that Jack has raised and your responses to it. But I said at the outset here about reconvening this group in 30 or 60 days. I know you are all studying these things, but what can the private institutions do? What do you need to do as regulators? And what, if anything, do we need to do up here to provide additional authority for regulators to implement regulations in these areas?

So I am very interested in getting down to the nitty-gritty here. What specific steps need to be taken? I think we can study this stuff endlessly, but my sense of urgency about this I think is very strong, and so I would like to get back fairly quickly with you on some very specific ideas on how we move forward.

With that, Senator Bennett.

Senator BENNETT. Thank you very much, Mr. Chairman. This has been a very interesting hearing, and I keep groping through my notes to try to come up with a worthwhile question that is responsive to your response, so if I might wander through some of my notes and then get your comments.

Mr. Dugan, you talked about the models that were used. Models are stupid. They do not do nuance. And the question is: At what level should the judgment come in, human judgment that says, well, the model may say this—your point was well taken that all of the data fed into the model was optimistic because we had had a good time, so the model will naturally project optimistic results. Now we are going to feed a bunch of bad data into the model, and the model is going to tell us the future is going to be terrible. And at some point, we need to inject some judgment in this. And I do not know whether that is at your level or whether it is something that the banks should do and you folks just look at.

My fundamental question as a policymaker dealing with this is: Where are we going? Are we going to work our way through this in the next 6 to 9 to 12 months? This was a bubble that burst. When the inventory overhang gets sold off, is it going to go away?

Mr. Gronstal, you send chills down my back when you say ag land is on the edge of having the same kind of bubble, because there has been tremendous bidding up of the value of agricultural land. And are we focusing so much on, gee, the banking system that we are not seeing that there is a potential out there—and this, again, comes back to the question of judgment of what are we doing.

A comment was made, I think by Governor Kohn, about it all froze up. Everybody was so anxious about getting capital into their institutions that they were unwilling to lend. And people who had absolutely nothing to do with subprime or housing suddenly could not get credit. And I certainly heard about that, and I am sure a number of Members of the Committee did.

So as I try to find out where we are going here, what is going to happen in the future, in addition to all of the things we have talked about—we need to fix the rating agencies, we need to change this, that, and the other—what do you see in terms of the economy? The Chairman quoted President Kennedy about if the economy is not right, there isn't anything that is right. How invasive is this crisis in terms of other areas just—other areas besides the question of the safety and soundness of banks? This is a judgment call, but you are all very knowledgeable, more knowledgeable perhaps than we. And I am sure you have thought about this and just share with us your sense of where we are and how soon there is going to be a rebound and how vulnerable are we to other problems and how badly is the economy hurt by all of this. Respond, if you will.

Mr. KOHN. Quite a set of questions, Senator.

I think there is no——

Senator BENNETT. They have all been spawned by listening to you.

Mr. KOHN. Right. There is no question that the turmoil in the markets has had effects beyond the mortgage market, as you say. Banks conserving liquidity and capital and concerned about the economic outlook, as you have enunciated, have become more cautious in their lending and not just in mortgage markets. But we survey the banks four times a year. Our last survey was at the end of January. And across the board, for every kind of lending, significant proportions of the banks said they were tightening terms and standards for making those loans.

Now, to some extent, this is welcome because I think lenders and borrowers did not fully appreciate the risks out there. The risk was underpriced, as many of us said, for the last several years. The very benign economic environment of the mid-2000s led people to get too complacent about the risks, and particularly about the possibility of an adverse event like an unwind in the mortgage market spilling over to other markets.

So I think to a certain extent the correction that is occurring in the markets is a necessary correction. But I do think that it is painful while we are going through it. It is not going to go away quickly. The economy has been hurt. That is why the Federal Reserve has been lowering interest rates, to cushion the effect on the economy of the tightening of credit that is going on throughout the economy as well as the decline in the housing market.

So our effort has been to provide an offset to this general restriction of credit in order to keep the economy moving forward.

Our outlook, as our Chairman testified before this Committee—last week, I guess—is that we will see a period of very slow growth, very sluggish economy. We have already had a fourth quarter which barely grew, according to the Bureau of Economic Analysis, and I think a lot of people anticipate that we are going to be in the neighborhood or just above zero for a quarter or two now. And in a sense, there is not much that we can do about that because policy acts with a lag.

But I do think we have tried to position ourselves with the extra push from fiscal policy that you folks, the House, and the President put together for the second half of the year, that the economy is in a position to rebound later this year. I think that at the same time, as Chairman Bernanke pointed out, I think there are downside risks to this forecast, and a lot of it comes from the financial market dynamics that we are talking about today.

If lenders become much, much more cautious because they are protecting themselves against very serious outcomes, not just a period of sluggish growth, that can have elements of a self-fulfilling prophecy in it that will damp spending. As spending is damped, they become more cautious.

We are very conscious of this, and that is part of the calculus in our monetary policy to try to think about whether we have adequate insurance against this downside risk to the economy.

I think progress is being made in the financial market. It looks very shaky. Every day there is some more bad news. I do not know what has happened today—other than this set of testimonies, and I hope that is not bad news. But I think there are some signs out there that we are working through the problem. There is greater transparency by firms with problems on their books. There is capital coming into the system that several of my colleagues have mentioned here on the panel, so people are raising capital. They are being much more open about what the issues are. I think part of this problem is about uncertainty. So increased transparency by lenders, by others with problems on their books is going to be very helpful to letting people know what the downside risks are, how to price them in, and I do think the markets have gone to a point where they are anticipating some pretty adverse kinds of outcomes in the housing market and in the economy to a certain extent. So they are in the process of pricing in the downside risks.

So my hope is that as they see the economy has stabilized, as they see the conditions are in place for a rebound next year, that confidence will return, trading return, and I think in the end, a year from now, we will have a safer financial market, one in which risk is priced better than it was a couple years ago, one in which there are fewer of these conduits and other kind of off-balance-sheet structures that have risks associated that people did not anticipate. So it will be a safer system. Banks will play probably a larger role in that system. Complex instruments will be less complex, more transparent. Credit rating agencies will do a better job. But it is not going to be easy getting from here to there.

Senator BENNETT. I am conscious of the time. I do not want to impose on——

Mr. DUGAN. I would just add a couple things because I think that was really an excellent answer. I think everybody is quite focused on this. I would say three things.

One, as Don suggested, I think there is an awful lot of attention being paid to working through the particular problems that are being raised. And while it seems like we have an endless stream of them, some of them the banking system has made significant progress on including dealing with the SIV problem or the asset-backed commercial paper funding problem or the inter-bank funding problem. The Federal Reserve and central banks were quite aggressive with liquidity, and it made a real difference.

There are other problems that are more in transit, and monoline insurance is one of those. We also have some more intractable problems about the residential securitization markets that are going to take more time and will lead to questions about house prices. I think there is an awful lot of attention being paid to what is going to happen to house prices.

The last point I would make is it is true that underwriting standards, at least at our banks, have definitely gotten tighter. But they are still making loans, and credit has been expanding, not contracting. It has not expanded to the same degree. It has definitely cut back, but it has not been a wholesale scaling back and contraction. I just want to make sure we underline that point.

Senator BENNETT. Thank you.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much. Very good question here. Senator Casey.

Senator CASEY. Mr. Chairman, thank you very much, and I want to thank the witnesses who are here for your testimony and for your service.

I wanted to direct your attention, first of all, to the subprime crisis, and I know we have talked about this in great detail. But I wanted to, first of all, ask Chairwoman Bair about parts of her testimony. In particular, I am looking at pages 16 through 18 where you address subprime borrowing, and I am just going to highlight part of your testimony and ask you to respond.

When you talk on page 17 about strategies here to deal with this problem, you talk about servicers should do the following: No. 1, identify loans facing likely default; No. 2, develop broad templates for restructuring these loans into long-term sustainable loans with fixed rates for at least 5 years; three, proactively initiate that process. And then you go on from there, and you talk later about the concerns that servicers have about potentially legal liability, and you also mention pursuing other strategies.

Give me your assessment as to where we are—when I say “we,” I mean the Congress, the administration, the various strategies across the country, the Hope Now Alliance, the whole effort nationally. Where do you think we are? What are we not doing, and what do we have to do to make progress to dig people out of this hole that they are in?

Ms. BAIR. Well, I think voluntary loan modifications are helping—they are ticking up. I am encouraged by the numbers that came out yesterday. I think we need more granular reporting to be able to fully assess how much they are helping.

We also need to focus beyond the reset problem. There is still a reset problem, notwithstanding lower interest rates. But we had very weak originations in 2006 and the first part of 2007, so a lot of those loans started going delinquent before the resets. And, of course, with declining home prices, a lot of people are underwater now, and so they are dealing with unaffordable mortgages and they are owing a lot more than their property is worth.

So you get into a situation where we were initially worried about forced foreclosures of people who have subprime hybrid ARMs. Now we need to worry about people just giving up and walking away.

So I think we need multiple strategies, and they need to be systematic because of the volume of the problem. And we do believe that that is consistent with the servicers' responsibilities. Most of these loans obviously have been securitized, and are owned by securitization trusts. But we believe systematic approaches are allowed by the pooling and servicing agreements that govern the servicers' obligation, and in point of fact are required to the extent that a loan-by-loan process is not feasible and is just going to lead to more foreclosures, which will end up costing the pool more. But it needs to be systematic, and servicers need to staff up. I think some of them are, but they need to provide standard benchmarks whether a debt-to-income analysis or standard loan-to-value ratios, whatever they are going to use, to make that clear to the staff that are dealing with the borrowers who are coming and looking for modifications. And borrowers in turn need to proactively interact with servicers.

Whether it will be enough, as the housing market goes down, I do not know. I think the jury is still out. We internally are thinking about other potential options that might be pursued. When I testified at this Committee in late January, I talked about the need to write down principal amounts of many of these loans to make them affordable and Congress made that a much more feasible option by passing the Debt Forgiveness Act in December so that a principal write-down would no longer lead to a tax liability on the part of the borrower.

That is going to be increasingly a tool that servicers should use. I believe there are ways to structure those principal write-downs so that there can be some type of shared equity agreement with the borrowers so that if the property starts going back up, there would be a way for the investment pool to share in some of that subsequent appreciation.

So I think we need to be looking at market-based solutions at this point, and keeping the pressure on for servicers to use systematic approaches, not loan-by-loan approaches, to deal with this, using the full panoply of tools available. Whether it will be enough, I do not know. I think we need a month or two more of data. I think, back to Senator Bennett's question, a lot of this is being driven by the housing market. How much home prices continue going down and how fast they go down I think will be a key indicator of whether we need to start being more proactive in terms of government intervention, but I do not think we are there yet.

Senator CASEY. Thank you, and I wanted to also ask a similar question to the Comptroller. I was happy that in your testimony, when you addressed the subprime mortgage crisis, what borrowers are facing, and the interplay between lenders and borrowers and servicers and borrowers, that you mentioned and highlighted counseling. I think the Congress moved with record speed in getting the $180 million approved, and that was done before the end of the year.

The recent legislation which the Democratic side of the aisle was pushing very hard last week and will continue to push added another $200 million to that. I am happy that you talk about that, and I am happy that the Treasury has highlighted it. I would urge you, using your skills as an advocate, to urge other Members of the U.S. Senate to make this counseling priority much more urgent and much more important. But I wanted to give you the opportunity to weigh in on this question about—not just about counseling, of course, but just overall how we are approaching this crisis.

Mr. DUGAN. Well, I agree with much of what Chairman Bair said. I think we do have a situation where 97 or 98 percent of Americans who hold mortgages are still paying their mortgages on time. We still have a situation where we have relatively low levels of unemployment in the country. We do have more aggressive actions being taken by servicers, but we do not know how effective that is yet because we have not had enough time to look at it and the metrics have not been good enough yet. We do not know yet how deep the house price decline is going to be, so I think the jury is still out somewhat.

As I mentioned in my testimony, we are requiring our largest banks, who service about 40 percent of the entire mortgage market, to do a much more detailed set of reporting of mortgage metrics on an apples-to-apples basis as a way to measure what kind of improvement is happening. That is not just with respect to subprime adjustable rate mortgages, but to all mortgages.

The other factor is, because interest rates have come down, the reset problem, which has not gone away, has definitely improved, and that is a good thing.

It is a mixed bag, and I think we are paying very close attention and monitoring our servicers. We will continue to do that. I know Congress will do the same, so I think the jury is still out.

Senator CASEY. Thank you very much.

Chairman DODD. Thank you very much, Senator. I am going to in the next go-round—those are very good questions Senator Casey has raised here, and I would note that this morning, apparently in a speech that the Chairman of the Federal Reserve has given to the community bankers this morning suggesting maybe something along the lines we have talked about earlier that the American Enterprise Institute and others have advocated, that I have been talking about, and that is this homeownership preservation idea, using existing platforms with very distressed mortgages.

It is a complicated issue. The devil is in the details in those ideas. It sounds wonderful in the first couple of sentences, and then you start talking about how you actually do this, and it gets a little more complicated. But, nonetheless, I appreciate the Chairman's at least acknowledging—and I am going to come back at my round here and ask all of you maybe to comment on that concept and idea and whether or not we should not at least be thinking about rather than waiting for something to happen. But I will raise that.

Senator Corker.

Senator CORKER. Mr. Chairman, I thank you, and being so low-ranking, I have the opportunity to hear a lot of great questions, and certainly some wonderful testimony by these panelists. I do think that this hearing has come at an excellent time. I really do. And I thank you for having it.

I think that what we have seen is that the banking industry in general is very strong, and I think that is good for us to know. I think that we are all out seeing and hearing about a lot of problems. But the fact is that due to the great work of our panelists and just responsible bankers across our country, and lenders, we are actually in a really strong place. And I think that is a message that we all need to soak in and know as we think about what we might do in the future as it relates to housing and other issues.

You know, the cheap and easy credit—and I do not mean to demean it, but, you know, today 10-year treasuries are at 354 and, you know, real estate valuations are simply a measure of what interest rates are. I mean, when interest rates are low, commercial values increase tremendously. It is hard for me to believe that commercial real estate has been selling at 5 percent caps, 6 percent caps, just ridiculously high prices. And there is no question there are going to be write-downs. People have made a lot of money over the last several years, and the chickens are going to come home to roost here in the near future. I think we all understand that.

The same thing I think we have all seen happen with housing is that people buy housing based on what the mortgage payments are. Let's face it. And when rates are low, they will pay more for housing, and we have gone through an incredible time of rising home prices. As a matter of fact, a few years ago we were all concerned and reading daily in Wall Street about the overheated housing market. And even though the Chairman, doing a great job, pointed out that housing prices had dropped 10 percent, we are still just back to some levels in 2006 that were at that time incredibly high. So I think your testimony today is very good to take into—is very good to help us with the perspective of where we are, and it is amazing that the banking system is so strong.

I think it is also interesting to note that the folks who are involved in CDOs, as you have mentioned, they have already taken their hits. And in many cases, they took too aggressive of hits, and it is those folks that did lending the old-fashioned way—they actually kept it on their balance sheet—those are the ones you are going to be dealing with here in the near future. They have not yet taken their write-downs. They will be taking—those that actually loaned money the old-fashioned way, the way we all used to borrow it.

So I guess I have really two questions. One of the things that I see in these cycles is we get exuberant real estate, the best thing there is in the world, and everybody invests in it and everybody loans money toward it. And then when problems occur, some of the organizations that you actually represent—and I think the Governor used the word I was going to use—actually create a self-fulfilling prophecy. What happens is you begin to clamp down, bankers are afraid to make loans, especially with no offense to you, OCC in particular goes in and all of a sudden commercial lenders are not in the marketplace the way they were. They no longer are looking—you all fill out these forms that they have to fill out. Their credit is rated.

I would like for each of you to respond to that, because I am concerned that you, in fact, could end up being the greatest problem that we have by helping create a self-fulfilling prophecy by causing these banks to tighten down more so than necessary.

Mr. DUGAN. Senator, that is certainly not our intent. As Chairman Dodd referred earlier, I sat behind this dais—not on the dais but behind it—and sat through all the hearings of a lot of bank failures in the 1980s and early 1990s from problems with commercial real estate.

I also was in Government at that time when people were complaining about regulators acting too stringently, including the OCC. One of the issues that people have pointed to was that, in fact, the regulators—partly because they were overwhelmed—waited too long to move in on some of these problems until they got too big. When they had to act, they had to act strongly. And it was criticized as being too tight.

We have tried to get out ahead of that. When we get into an economy and part of the credit cycle, we begin to experience losses, bankers cannot turn a blind eye to that. They are going to experience losses, and they have to be realistic about the problems of their assets on their books. But we want them to be realistic. We do not want to make those write-downs. We want them to make realistic judgments, and to have realistic appraisals about what is going on in the commercial real estate market. We want to work with them. We want to work through these issues when they are smaller so that we can work through them instead of waiting until they get too large, and then the actions we take have a more dramatic effect.

That is an art, not a science. We have been quite forward leaning and proactive in trying to get bankers to understand that and to take good, strong measures about how they manage the risk in these times.

The one thing that is different this time around—and it is a significant difference—is that community bankers in particular have much bigger concentrations of their entire balance sheet in commercial real estate assets, and that can make it more difficult. It does not take as big a problem to cause as big a problem. But we are very mindful of this balance, and, again, our consistent message is bankers need to be realistic about the actual value of the assets in their portfolio and take realistic write-downs and provisions as they occur. We do not want to overdo it, but there has to be a measure of realism, or else the problem will get worse.

Senator CORKER. And I think it is not so much the write-downs as much as the future lending practices as a result of people having fears. And I would just say to you we are getting calls from board members, you know, who are concerned because the OCC is coming in and causing things to have to fit into a different and smaller box than in the past. And I would just urge you—it sounds like to me you are very sensitive to the issue, but I would just urge you not to exacerbate the problem by causing—and you have got a lot of folks who work with you throughout the country. Some are more exuberant than others, if you will. But I think that in itself could be a big factor as to whether we move through this period of slowed growth in better ways or not better ways.

Mr. DUGAN. Senator, we work very hard to have a measured, even way that we do things with our examiners. I do not think there is any issue in our community and mid-sized line of business that we spend more time on than having a consistent message about this.

To the extent that there are problems that you hear about that you want to pass along to us, please do that, because, as problems occur, we want to hear about them. There is also a question of when there are problems, people are going to complain at times, and we understand that, too. We have to do our job.

Senator CORKER. And, again, my comments are really focused more on the past and the fact that I do think the OCC has in the past exacerbated problems instead of helping them. And it sounds like you are very sensitive, and I appreciate that.

I wonder if—I guess I am out of time. I will wait until the——

Chairman DODD. No, no. You have got a couple more seconds.

Senator CORKER. Let me just on the transparency issue, the issue of transparency, these complex financial instruments—which were great as long as nobody had to actually own them. You could make fees selling them to each other, and everybody was having a great time until somebody had to actually value those.

I was up at the stock exchange—I have mentioned this once before—a couple weeks ago and noticed they are setting up a mechanism where you can actually in real time instantly value the debt instruments you have on your books. And I am just wondering if—you know, to have the same kind of transparency and valuation that we have in equity markets. I am wondering if any of you have comments about that or other things that might occur to keep these complex vehicles in the future from being—the values made up, if you will, and fees really being generated to banks simply by trading them with each other, slicing and dicing and selling them back and forth to each other.

Mr. DUGAN. I will start. Valuation, of course, is a critical issue that we have seen. Part of the problem has been when all trading stops in an asset that is itself very complicated because it is based on a whole waterfall of different cash-flows from many different underlying mortgage-backed securities, it is very difficult to get that instant value when you do not have market prices to look at. And part of the problem that we have seen is not that people relied on very complex models that were problematic. Quite the opposite, it is that they did not have very good, robust models that were complex enough and sophisticated enough to really accurately measure what these things were worth when there was not a market price for them. That is one of the things that we are spending a great deal of time looking at. The whole issue of valuation and transparency and how we deal with them has played a critical role in the disruptions.

Senator CORKER. Thank you.

Mr. KOHN. I agree, Senator, and I think that to some extent the market is in the process of taking care of this. The participants in the market understand that part of the problem here was the complexity and opacity of the instruments. As I said before, it made it very difficult to look through the credit rating agencies' analysis to the underlying instrument.

So I think going forward, at least for a while, we will have instruments that are easier to value and to market. But I think it is very important that, as regulators, we not impede and, if anything, encourage that movement by the credit rating agencies, by the banks, that they be able to have an independent assessment of what the value of the assets are and not rely on the credit rating agencies, for example. So I think that is an important part of what we need to do here.

The valuation question is very hard, as the Comptroller said, when there is not a market or not even a closely related market. I think it is important, to go back to a previous comment he made, that these things be valued realistically and that people looking at the banks, the investment banks, have confidence that they are valuing them realistically and are not inflating those values. And it is really up to the banks, the investment banks, to be transparent enough about their valuation methodologies to convince people that is it, and that will begin to restore confidence in the markets.

Ms. BAIR. I would just add that I think some public pricing mechanism would have been very valuable. I think it is very difficult to mark-to-market when there is no market. And I think we should all give further thought to whether regulated exchange type mechanisms could lend themselves to some of these instruments that now are privately traded. But I do not think any public market would function given the lack of information about these instruments. The core of the problem is lack of transparency, getting information out of that underlying asset quality so investors can make an intelligent pricing decision, and then some type of public trading mechanism might work.

Senator CORKER. Thank you, Mr. Chairman.

Chairman DODD. Senator, thank you very, very much, and as the panel can see, your job now is to find that pathway between Senator Corker and Senator Dodd in how you respond to all these questions here. But I appreciate Bob's contribution to the Committee, very knowledgeable and a very great asset to the Committee.

Senator Schumer.

Senator SCHUMER. Thank you, and thank all of you for being here and for the difficult job you have to do.

I have 3 different areas I would like to question. I would like to go back a little to the credit rating agencies. Senator Reed did a few questions on that.

But I still scratch my head about how these credit rating agencies operated because many of us knew there were problems in the mortgage market and what was happening, particularly with subprimes. I mean, we knew them on an anecdotal basis. And the credit rating agencies just seemed to sort of rubber stamp them. And I guess their model was housing prices will increase, it does not—how could credit rating agencies just automatically give AAAs to no doc—you know, to a whole bunch of securities that contain no doc loans? You do not know if the person has the ability to pay. You do not know any of these things.

And so, I would like to come back to this area of credit rating agencies. They just seem, to me, to have—from an outsider—to have just sort of gone through things in a mechanistic type way. And part of the reason, I think, or at least worth exploring, is conflicts of interest. I mean, you pay the credit rating agency—the issuer pays, and pays after they get the rating. Well, what does that say?

And so my question to you is does this model of credit rating agencies not work? Are you recommending to your institutions that they rely less on the credit rating agencies?

On the one hand you have simple mortgages where they messed it up. And on the other hand, as you just talked about, they have these very complicated financial instruments that I do not know if they understood.

You know, when CEOs of banks tell me they do not understand these complicated documents, somebody in the middle of the bank does. Do the credit rating agencies understand them?

Something is really wrong. And I think ultimately, when we look back on this, we are going to see that the banks relied, the credit rating agency, boom, they give the Good Housekeeping Seal of Approval, and everyone just goes ahead on their merry way.

Don't we need a fundamental re-examination of A) how the credit agencies function, maybe going back to the old model, where the investor paid rather than the issuer paid. And second, aren't you telling your banks now that they are going to have to do much more of their own examination rather than just rely on the credit rating agencies?

Sheila Bair.

Ms. BAIR. Well, I think a lot of those issues, we do not regulate the rating agencies——

Senator SCHUMER. I know you do not.

Ms. BAIR. I think certainly we would be——

Senator SCHUMER. The institutions you——

Ms. BAIR [continuing]. The banks have been having——

Senator SCHUMER [continuing]. Regulate reliably——

Ms. BAIR. Yes, and we are certainly highly supportive of the steps that the rating agencies have taken on their own, as well as steps the SEC has been taking and may plan to take in the future.

As a bank regulator and as an insurer of all banks, I am very uncomfortable with continuing to allow banks to set capital based on external ratings for structured finance when we do not know what the underlying asset quality is. The rating agencies use mathematical models. They never looked at underlying asset quality.

Senator SCHUMER. Exactly.

Ms. BAIR. For some of these, it would take weeks and hundreds of thousands of pages to even find the underlying assets because they have been sliced and diced so many times.

So we need to get back to basics. And again, the core is that you need to know what the underlying assets are ultimately backing those securities. And if you do not have that information, you cannot price.

Senator SCHUMER. And they did not. And they did not have that information.

Ms. BAIR. They relied on mathematical models. So even if you were over-collateralized, basically the risk was that the higher tranches would not be covered—it was all done with the math.

Senator SCHUMER. Governor Kohn, do you want to comment on this?

Mr. KOHN. Yes, I do. I am sorry, do you want to go ahead?

Senator SCHUMER. Go ahead, Mr. Gronstal.

Mr. GRONSTAL. State regulators, as we evaluate bank management, we hold them accountable for understanding what investments they make. And when they make errors, we make them charge it off. And I think that is pretty much the same way the Federal regulators do with their banks.

And these were very complex instruments and I think——

Senator SCHUMER. The mortgages were not complex.

Mr. GRONSTAL. No, the mortgages were not, but the securities, the way they got packaged up——

Senator SCHUMER. With all due respect, when people walked into my office and told me the mortgage they were sold, I said you will never be able to pay that back. Your monthly payment exceeds your annual income.

Mr. GRONSTAL. Unfortunately, a lot of people relied on the loan officer to tell them how much they could afford. And the loan officer was compensated on the size of the loan. So there was kind of a perverse incentive to make the loan too big.

Senator SCHUMER. Right. Governor Kohn.

Mr. KOHN. Yes, Senator, we are telling our banks to rely less on the credit rating agencies and to look at the underlying collateral, the underlying securities, and make their own judgments.

And I think, as Comptroller Dugan said, there was just too much of that reliance before.

I think, I am not sure that there is an alternative to the issuer pays model. What I was told was that the investor pays model was in effect until the Xerox machine was invented, and then it was really impossible to control.

Senator SCHUMER. And they were private. The investor paid was not made public. And you do want some kind of public rating available.

Mr. KOHN. That is right, and those ratings are used. So I think there is probably, in the end, no alternative to the issuer pays model. But I know that the SEC and other regulators are looking carefully at this conflict of interest question that you raised. The credit rating agencies have an interest in doing a good job. They have their reputation on the line. But obviously, that was not enough.

Senator SCHUMER. No, they got very sloppy, obviously.

Mr. KOHN. They got very sloppy and they were not really looking—they were taking other people's word for what was in those packages. And they were not drilling down and doing their own inspection.

Senator SCHUMER. Exactly. You have sort of——

Mr. KOHN. They need to find—they need either to take total responsibility themselves for looking at what is happening at the originator level, or they need to find another way of putting more pressure on the people who are packaging——

Senator SCHUMER. It was almost a catch-22. The agencies relied on the banks for it, and the banks relied on the credit agencies. And look where we are now.

OK, second area I would like to—my time is limited and I know you have fully opined on this, Comptroller.

And that relates, Senator Dodd asked some questions on Basel II. And here is the dilemma we face: these markets are now international. All the problems in the U.S. have affected a lot of western banks outside. And yet the standards, even with the efforts of Basel II, are not international. You have still efforts by countries to have an easier system of regulation so that money will flow in that direction because it is cheaper if there is less regulation, fewer capital requirements.

And you sort of get a race to the bottom and then that ultimately leads to the undoing of the financial system, which we have seen now.

So how do you balance the need for some stringent regulation—admittedly some of you have stated that Basel II did not do the job or will not do the job. Obviously, it is not to blame because it has not happened yet in America, although it is in Europe.

But how do you balance, how do you get sort of one international standard here, which is what we need, without individual countries sort of playing one-upmanship with one another? Isn't that the fundamental problem we face here? Because in good times, everyone is going to want to reduce the standard. And then in bad times, that reduced standard affects everybody, whether you have reduced the standard or not.

Go ahead, Comptroller, and then Ms. Bair.

Mr. DUGAN. I think the whole point of Basel is to have some international minimum standards that everybody has that you cannot go below. Then there are questions about how much people add on in different areas.

I actually think there has been progress to raise that across the board. Basel II is a step in the right direction, as we talked about earlier, because it is more related to risk, but it does have some issues that we have to address.

I think it is fundamental to keep those efforts going. Personally, based on many discussions that I have had with international supervisors, it is not a race to the bottom. I think there really is an effort——

Senator SCHUMER. So you think the framework can work?

Mr. DUGAN. Absolutely. And I would say the biggest single difference between my being in Government this time than 15 years ago is there is much more cooperation and much more awareness that we have to have and work toward a common set of minimum standards because this is a global world.

Senator SCHUMER. Exactly. We are one international economy. No one can build a wall. Ms. Bair.

Ms. BAIR. Well, I am concerned that the models serve an approach under the Basel II framework that actually is going to feed into more of this race to the bottom competition because it is much more subjective.

First, under Pillar 1, you rely on each individual bank's own internal models to set capital. Those are validated by the individual supervisors of that country. We have been told that if the models are too low we can correct them under Pillar 2. Again, that gets back to supervisory discretion. So not only is it jurisdiction by jurisdiction, it is bank by bank.

We have called for some international agreement on hard and fast supplemental capital standards, dare I say it—an international leverage ratio—or something like that. But something hard and fast that will set a minimum for all banks.

The Financial Times ran an editorial a few weeks ago showing that a lot of major European banks are critically undercapitalized by our own PCA standards. This is something that everybody should be——

Senator SCHUMER. Despite Basel II.

Ms. BAIR. Yes.

Senator SCHUMER. Exactly, because they were seeking an advantage, I guess, each individual country or regulator.

Ms. BAIR. There is a tendency, which is why Chairman Dodd mentioned the inherent conflict of using internal models to set capital. Because sure, if you lower your capital, you are going to increase your return on equity. Absolutely.

Chairman DODD. I said it was like modeling weather reports. If you only use sunny days, you are going to set sunny day modeling. You have got to stress those models.

Senator SCHUMER. But during the sunny days, the sunny day user has an advantage over the cloudy day people.

Mr. REICH. Senator Schumer, I would like to add that as a member of the Basel Committee I have sensed, in the last year particularly, with the losses that some major foreign banks have taken in the past year, that there is much greater acceptance of the members of the Committee from our foreign regulatory counterparts to accept more stringent controls and additions to Basel II.

Senator SCHUMER. I will just conclude here—my time is expired. But if there were ever a time to get everybody to sort of agree to have that minimum standard without, as Ms. Bair points out, the ability to go below it and get around it, now is the time because we have seen the—I agree with Ms. Bair here. There is something of a race to the bottom despite Basel II.

And if we can now sort of tighten that up, now is the ideal time to do it because people have suffered from the lax standards I see.

I am just going to have the record note that Governor Kohn was nodding his head in agreement.

Mr. KOHN. Up and down.

Senator SCHUMER. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much. Senator Carper.

Senator CARPER. Thanks, Mr. Chairman. And our thanks to all of you for being here today.

I wonder if you are going to be testifying on Thursday. We have a hearing on GSE-regulatory reform? No? OK.

I said earlier, when we were giving our opening statements, that our leadership brought forward a package that is designed to help with housing recovery. We had an opportunity to vote whether or not to proceed to that legislation last week. We could not get to 60 votes to proceed.

And in the days that have followed, we have seen an effort on the part of our leadership in this Committee and others to try to find out how we can construct a package that has buy-in not just from Democrats but Republicans, as well. And also from the Administration.

I just want to run through quickly maybe the 6 major elements of the proposals cobbled together by the Democratic leadership and just ask you to just tell me whether or not you think it is a good idea.

And then I am going to do the same thing with some other ideas, some from our Republican friends, and just ask you to see whether or not you think—without getting into a lot of detail—whether or not that might be a good idea, as well.

One of the proposals is to increase pre-foreclosure counseling funds by about $200 million nationwide. If you think that is a good idea or you do not, just tell me. Just start, Ms. Bair.

Ms. BAIR. Well, I think counseling is a very good idea. I know NeighborWorks has gotten a significant infusion already. So my only caveat would be how much they can use, how quickly, and how effectively. But certainly, the modification process is a highly complex one and we need intensive counseling and help.

So I think to the extent you are increasing borrower leverage to be able to negotiate a loan modification, that the counseling process is helpful.

We do not have a position on the dollar amount, though.

Senator CARPER. OK. Is there anybody at the table that has a different opinion than that that Ms. Bair has expressed?

Mr. REICH. I do not have a different opinion, but I am on the board of NeighborWorks and I know that they have been working very hard in recent weeks to allocate the $180 million that was appropriated to a variety of counseling agencies around the country.

It is a challenge to make certain that those funds go to the appropriate organizations who have the capacity to counsel many people. So the addition of another $200 million on top of the $180 million in a short period of time might be a bit problematic.

Senator CARPER. OK, thank you for that thought.

The second ingredient is to allow housing finance agencies to issue bonds for refinancing. They can already issue bonds that are used for first-time home buyer programs, to use to develop multifamily rental housing.

But this is a little different. First, I think this is one actually the Administration favors, too, in testimony before us by Secretary Paulson a couple of weeks ago. Your thoughts on whether or not that is a meritorious idea?

Ms. BAIR. Well, yes. This is not my area of expertise, tax policy, but I know I have certainly read the Administration's statement on this and know of the bipartisan support. So yes, intuitively it seems like a good idea.

Senator CARPER. OK. Does anybody have a different view?

Mr. DUGAN. Senator, I just have not looked at these particular policies and I must say I am quite uncomfortable passing judgment on how much——

Senator CARPER. I understand and you were fair to say that. You are fair to say that.

My other proposal is to provide an additional $4 billion in CDBG funds to purchase foreclosed homes. We have actually allocated in our budget for this year, I want to say about $3.6 billion. So this would actually be more than we have already allocated for the current fiscal year.

Does anybody think that is a particularly good or bad idea? Anybody at all? Mr. Kohn? Do people call me Governor?

Mr. KOHN. Fine.

Senator CARPER. They call me that, too. Do you like it?

Mr. KOHN. Like John, we——

Senator CARPER. I still like it.

Mr. KOHN. We have not looked at these issues so it is hard to have an opinion without——

Senator CARPER. All right. Fair enough. I understand.

There is an issue on bankruptcy. Initially the proposal on bankruptcy or cram down was pretty broad and it was prospective, not retroactive. I did not just focus on subprime mortgages, but it was very broad.

It has been modified so that the proposal would apply only to current subprime mortgages. The judge could reduce the interest rate to prime plus a reasonable premium for risk. The judge could extend the life of the mortgage, I am told, by some 30 years.

Does any of that make sense to you as part of what we are trying to get at here? We have had some concerns raised that if we provide for this kind of opportunity in bankruptcy that we run the risk of raising the cost of mortgages, that the interest rate might go up for primary residences. That is the caution that we have heard.

Any thoughts?

Mr. REICH. I would share that caution, and as well be concerned about the potential impact on investors returning to the market.

Senator CARPER. Senator Martinez and Senator——

Chairman DODD. Just to point out, if I can—and I appreciate John Reich talking about that—there is a history to that provision that goes back to the 1970s, where that was the negotiation that went on with the lending institutions, to provide money to otherwise risky borrowers in exchange for that was to provide some protection under the bankruptcy act.

So the history—I am not necessarily endorsing a continuation of it, but sometimes we mention these things in a vacuum and do not appreciate there is a history and a rationale for that.

Senator CARPER. I understand. Thank you.

I think Senator Martinez has a proposal that addresses appraisals. If you have any thoughts on this, we would appreciate it. His amendment would tighten the standards currently in place for appraisals. The amendment would require a written appraisal and physical visits before granting a mortgage, ending the current practice of drive-by appraisals.

Does that make any sense in the context of a mortgage or housing recovery package?

Mr. REICH. It makes sense in the context of what acceptable banking practice ought to be. I think most community banks try to do those things today.

Senator CARPER. Senator Feinstein has a proposal to license mortgage brokers. And that is just a thumbnail sketch. Does that strike any of you as part of the package of things that we should consider doing, to license mortgage brokers?

Mr. GRONSTAL. From a CSBS standpoint, we think that is an appropriate thing to do. And that is why we have developed the national mortgage licensing system. So we think that is something that we need to support.

Senator CARPER. All right, thank you. Yes, Mr. Dugan.

Mr. DUGAN. Senator, we would agree that an effective licensing system for mortgage brokers is an important component of this, because I think one of the problems that we had underlying all of this is the ability to get even underwriting standards, not just for those loans underwritten by banks and banking organizations that are subject to our supervision or to State bank regulator supervision, but to get the same standards to apply to non-banks and to brokers that work in the origination process and are not subject to the same regulation and supervision.

An effective licensing scheme could help that process. I am not sure it is a complete solution but it is something that could be helpful if implemented correctly.

Senator CARPER. All right, thanks. Ms. Bair.

Ms. BAIR. I would—yes, I think that would be extremely helpful. I used to work on the securities side, as you know. And when I contrast the extensive licensing and continuing education regime for securities brokers and their elaborate system of self-regulation and compare it to what we have on the mortgage brokers side, it is a very stark contrast.

So if you want to have a $2,000 mutual fund investment, the protections there are much, much stronger than if you want to buy a $300,000 house. So I think that is absolutely an area of concern, and it goes beyond what the regulators could do.

So I think I would absolutely urge action in that area.

Senator CARPER. I would just say to our leaders on this Committee, if we were in a position to go back and revisit this issue of a housing recovery package, the last provision there is actually a Feinstein and Martinez proposal that sounds like it might——

Chairman DODD. I will tell you, it is also one we have introduced in our own legislation we have drafted here as a comprehensive, addressing the question.

What we are trying to do is something here, if at all possible, to raise—of course, to deal with some emergency steps that we might take. Some of these ideas are far more far-reaching here. Very meritorious, but I think the goal of trying to get something done, a narrow idea, is what we are still working on. And hopefully maybe we can get something done before the Easter break.

As the Senator knows, I have a deep interest in getting something up. But our ability to do that is going to depend on whether or not we get some comity and some agreement on these principles.

Some of these ideas, while I am supportive of them, I realize they are going to be rather contentious and are included in a larger package. But I want to wait until we maybe do that under a way so we get it done, if we do not sacrifice getting something done.

But let me, if I can, I appreciate——

Senator CARPER. Thank you.

Chairman DODD. I just want to raise a couple of questions. Senator Shelby has a couple of questions, as well for us.

Let me step out of—you know, it seems to me here, as I am looking at all of this, there are 3 sets of issues we are dealing with. One, how do we avoid this from happening again, and the kind of steps we can take? How do we deal with the problems that people have, whatever they may be, that are suffering as a result of the problem? That is, dealing with foreclosures.

What we are not seem to be addressing is the problem. We are dancing around this, trying to shut the door to make sure it does not happen again, and how do you address the issues that people are affected by this?

I want to raise with you, Governor Kohn, if I can, an idea. This is just an idea, and something that you might have heard about yourself. And that is how do we—the freezing up of credit. How do we sort of unleash this credit freezing issue, which is at the heart of it in my view? More than anything else, that is the heart of this issue.

And one idea that was suggested, trying to get people to think out of the box a little bit here, is to make available to the discount window private investment institutions, provided they be subject to Federal regulation, provide the necessary collateral and the like, so it just would not be the member banks that would access to it.

This is a rather radical idea, to some extent. But to the extent you could send positive optimistic messages here about releasing the kind of—the rigidity that the credit markets face here. What is your reaction to something like this? Have you heard of this? Others may have raised this.

And if not that, are there some other thoughts that we ought to be considering? That we all ought to be considering as a way of trying to deal with the problem, other than just, of course, making sure we shut the door so that it does not happen again and dealing with those who are affected by it, how do you deal with the central question that will bring us to some quicker conclusion to all of this?

Mr. KOHN. I certainly have heard proposals to open the discount window to a broader array than just depository institutions. Technically, it is possible now——

Chairman DODD. You have the authority now to do that. It would not require legislation, would it?

Mr. KOHN. Under Section 13.3 of the Federal Reserve Act, we can make loans to individuals, partnerships, and corporations under unusual and exigent circumstances by a vote of no fewer than 5 members of the Board of Governors.

And we have not made any such loans since the 1930s. So Congress saw this as an emergency very, very unusual situation that they did not want us using.

I would be very cautious about opening that window up more generally. I think the banks have access to the discount window but the quid pro quo, in some sense, or the control—there is a moral hazard issue here, having them have access. And the control on that is this panel, right? You have an extensive amount of bank examination supervision. You have constricted their activities in a number of ways relative to investment banks.

I do not think that liquidity is the problem for the investment banks, or liquidity is the issue behind restarting these markets right now. I think it is about confidence. It is about the underlying economy. It is about the housing market. So I am not going to trade these securities until I can have some confidence that I can estimate the losses embodied in them, that I can price them in a way that will be sustainable.

Chairman DODD. I agree with that. It is kind of a chicken and an egg though, too, a little bit, isn't it? I mean, you get confidence, in a sense, if you also have access and liquidity.

Mr. KOHN. Right. But I think it is also more of a capital problem, not so much capital in the banks, per se. But just the whole sense of losses and potential losses if the economy deteriorates further. So I do not think opening up credit to the investment banks will really be that helpful in the end and could carry some very major costs.

Chairman DODD. Well, I certainly agree with your cautionary note in all of this, and what is why I raised it and framed it the way I did. It is an idea that has been kicking around.

Anyone else have any reaction to this at all? John, do you have any reaction to this?

Mr. DUGAN. As an old Treasury guy, too, I do have a reaction, which is you have to be very careful about giving out the Government's credit except to institutions that you really pay very close supervisory attention to. I would maybe even be more cautious than Don about this.

And I think he is right. I think the issue has not been primarily about getting access to liquidity. It has been about what is going to happen to house prices. That is what everybody is looking at, before they go back into the housing market.

I would just echo the very extreme note of caution.

Chairman DODD. Well, let me also just, if I can, I mentioned earlier this issue of jumping back to the issue of what do we do about those who are facing foreclosure. And as you all know, we have resets coming along here. I am hopeful that the Hope Now Alliance is going to work.

There are some reports this morning that we may be getting more done than we had hoped. Certainly, the last year was not terribly encouraging. But obviously, if things are picking up a bit, that can be helpful.

But the numbers could increase here. And now it looks as though a significant percentage of these foreclosures are not just in the subprime but prime and credit-worthy borrowers that are facing these problems, as well.

And I want to raise the issue again of this idea—and again, I do not want to put words in the Chairman of the Federal Reserve—I did not read his speech yet. But I gather something along the lines of maybe being a bit more aggressive on this issue than just the Hope Now Alliance would indicate may have value here, including the idea that I have raised and others have raised.

Chairman Barney Frank is talking about some ideas over there that are not dissimilar to the ones we are talking about.

And again, you can wait for this to happen and try and do something. But again, the idea of putting something in place that requires some real work, because there are legitimate issues that get raised when you start talking about establishing—whether you are using a separate entity or utilizing one of the GSEs or using FHA. In any case, the details of this get very, very complicated.

And my concern is that if we wait too long and we find this problem getting worse and try to deal with it on that level, that we may miss an opportunity to step up. And I just would like to get, those of you who are interested in commenting on this idea. As I pointed out earlier, the American Enterprise Institute and others have testified favorably about the idea.

Sheila, do you want to comment on this? And just run down the table quickly.

Ms. BAIR. Well, yes, I think we should be looking at all options. I really do. I think the jury is still out on whether we will need to set up something quite major. But I think your thinking is right, whether it is a new agency or FHA or one of the current GSEs. If that greater level of Government intervention is necessary, this is something that we should all be thinking about now.

But I do not think we are there yet in recognizing it.

I would say, as another former Treasury person, that if we do set something up the moral hazard is significant. The risk of gaming is significant. And I would strongly recommend a mechanism to pay for it, hopefully paid by the people who would actually be using it and benefiting.

Chairman DODD. John, do you have any comment?

Mr. DUGAN. I agree with Sheila and I do not really have much to add to that, particularly since, as you said, I have not really looked at the particulars of it. We are not—thankfully—yet anywhere near what we were in the 1930s when we had a much bigger proportion of people foreclosing their homes. We have still got a relatively small part of the overall population of mortgage holders. The jury is still out, before you engage in this.

And also, it will take a long time to get it up and running, and that is part of your point I know. But I do think in the meantime we should not lose our focus on the other things that we are doing. But I share Sheila's thoughts.

Chairman DODD. Anybody else?

Mr. REICH. At OTS, we have been——

Chairman DODD. You have been particularly good on that. I want to thank you, by the way, John. Your ideas, while I am not signing on to every dotted I and crossed t, I appreciate the effort of thinking about some ideas like this.

Mr. REICH. Well, and it is not—to be honest, it is not fully developed yet.

Chairman DODD. I know.

Mr. REICH. We put it out last week. We are talking with people at this table. We have a meeting tomorrow with securitizers and another meeting Thursday with regulators.

But trying to find a way to use existing programs, existing delivery channels without creating a new entity that would deal with those people who are under water in their mortgages.

Mr. KOHN. I think the message of the Chairman's speech—and I had only myself a chance to read it very quickly—is that, consistent with Sheila's first comment, all options should be on the table and we should continue to think about these things.

But I agree with the cautions that the others noted. I think looking at existing programs and how to do it better, perhaps to expand them, the FHA for example, is probably more efficient, more effective.

I think one of the issues we are dealing with here is—and people mentioned this earlier—on the borrower's side, getting the borrowers to contact their lenders has been very difficult. There are a lot of fears there, I am sure, about what you will find.

And I do not have a quick fix for this, but the people I have talked to involved in this have said that one of the barriers to scaling up this process is having borrowers call in. The Federal Reserve Banks are very involved, working with community groups, lenders and borrowers, trying to get the word out. It is not a magic bullet to fix this.

But I think we just need to work on all fronts to get these borrowers and lenders together.

Chairman DODD. Tom.

Mr. GRONSTAL. I think it is obvious that until we can figure out what residential properties are worth in individual markets, it is going to be very difficult to decide how much can be loaned against them. And it is just going to take time to work through that.

Chairman DODD. Let me again, I do not want to get anecdotal, but just in Connecticut now, I think it was ranking like number 8 in the States with the foreclosure issue. We had almost 50,000 of them in Connecticut last year. I have mentioned before some 6,000 just in one city, potentially, in the city of Bridgeport, Connecticut.

And we are getting calls in our office, and I use their words, it is anecdotal. But the run-around by the Hope Alliance.

And I really use this forum here, even some of the consultants involved in this are raising some issues about how well this working, going to the very point you talk about. If that confidence is not there of that borrower to call and feel as though there is going to be some effort made here—I am not suggesting that every one of these callers deserve, necessarily, to get the help. But nonetheless, I have to raise the issue here that people need to make the calls. But when that call comes in, they need to have a person on the other end of that line that is going to be sitting there and very receptive to trying to help work things out. So I want to mention that to you.

Senator Shelby.

Senator SHELBY. Thank you, Chairman Dodd.

In a speech delivered last week, Comptroller Dugan discussed how banks, credit rating agencies, and regulators all failed to adequately assess the risk presented by collateralized debt obligations. Comptroller Dugan noted that regulators neglected to properly scrutinize super senior tranches of certain collateralized debt obligations which are now being drastically revalued and causing large losses for banks, as all of you know.

He also indicated that bank underwriting standards were inadequate.

Governor Kohn, would you explain—you are not only a member of the Board of Governors, the Vice Chairman of the Fed, but you are a big bank regulator. Would you explain why the Federal Reserve failed to take steps before the advent of the current market turmoil to make sure that banks under your supervision fully understood the risk presented by structured finance products, did not overly rely on credit ratings when making loans, or that banks simply followed sound underwriting practices?

I know that where we are today, but a lot of people believe that the Fed was asleep at the switch in dealing with a lot of the big banks that you supervise.

Mr. KOHN. Senator, I think we have been aware for some time that risk was not being appropriately priced, that people were taking risks that they were not adequately insuring against, and that risk management systems in these various institutions varied greatly across institution and we——

Senator SHELBY. What did you do about it, though?

Mr. KOHN. We have been——

Senator SHELBY. If you were aware of it, as a supervisor of the banks?

Mr. KOHN. We have been working with the other supervisors to evaluate those risk management systems. And we started before this turmoil broke out, and to try and draw some conclusions about how these systems needed to be improved.

So I think we were not looking maybe at specific instruments and whether they were being value rated, but whether the systems were in place. And that is really—because that is what is going to protect us against the next issue. So just honing in on a particular instrument is not going to be helpful when there is another thing out there somewhere.

So I think it is the systems we need to pay attention to.

Senator SHELBY. Well, what happened to the basic bank prudent lending in this area?

Mr. KOHN. I think people got complacent.

Senator SHELBY. Got carried away?

Mr. KOHN. Absolutely. Because of this period of good macroeconomic performance, low—I mean, as Chairman Bair was saying, we had no bank failures for several years. This is a highly unusual situation.

Chairman DODD. Would you apply that word complacent to the Fed, as well as to the bankers?

Mr. KOHN. I think the Fed was less complacent, but I do not know that we fully appreciated all of these risks out there. I am not sure anybody did, to be perfectly honest.

There were——

Senator SHELBY. Well, why didn't you, though?

Mr. KOHN. I think we recognized that——

Senator SHELBY. Senator Dodd used the word complacent. You know, when good times are rolling along, people do become complacent.

Mr. KOHN. And a number of us gave speeches warning against this. And our supervisors were aware of that. Certainly, there is a lot of conversation back and forth about that. And I think they were moving in the direction of trying to correct this, trying to make the banks aware.

It is a very hard sell to the banks.

Senator SHELBY. It is a hard sell to the banks, yes. But you are the supervisor of all——

Mr. KOHN. That is right.

Senator SHELBY [continuing]. The bank holding companies.

Mr. KOHN. That is right.

Senator SHELBY And you are also the central bank. So you have not just a little bit of power, but a lot of power.

Mr. KOHN. I agree

Senator SHELBY. Were you reluctant—not just you personally. Was the Fed reluctant to use their power? Were they afraid of the banks that they regulate?

Mr. KOHN. No.

Senator SHELBY. Well, what were they? What happened?

Mr. KOHN. I think some banks did not take adequate steps. Now we are doing a study, as I noted in my testimony, of lessons learned. We did not perform flawlessly. I absolutely agree with that.

And I think perhaps when we get finished with this, one of the lessons that we will have learned is we need to be more forceful in these types of situations.

Chairman DODD. Can I pick up on Senator Shelby's question and add on to this thing? At the very time, just going back, you had promoting of the adjustable rate mortgages out of the Fed. You were raising interest rates at the time. Wasn't anybody—this is not a complicated set of questions.

You are pushing ARMs and you are raising rates. It seems to me, you have got a perfect storm on the horizon here, that you had to be aware of the potential of that. Any answer to that, looking back and saying maybe that was not wise?

Mr. KOHN. I am not sure that we were pushing ARMs. One person made a speech suggesting that.

But I do think consumers, households, the structure of interest rates anticipated the rise in rates and people should have been able to see that if they were borrowing at a low rate now, when that reset after a year or 3 years or 5 years, it was going to be at a higher rate.

So it is obvious that people did not see that. It is obvious that the lenders did not take appropriate account of the affordability of the loans when they were being made, as they reset.

I think, as several of us have mentioned today, a problem was that people were counting on those house prices to rise forever. And therefore, especially in the mortgage market, the due diligence about whether these loans could be repaid under other circumstances just was not undertaken.

Senator SHELBY. Senator Dodd and I have both been on this Committee quite a while, and I chaired it for 2 terms of Congress. But we were here during the thrift debacle. And we worry about it. I have talked to Chairman Bair. I have talked to all of you at different times about this.

We have a responsibility, here in the Senate, dealing with everything of the bank. But you have that responsibility at the Fed, and the others. But I believe the Fed was asleep.

I want to pick up, and I am glad that my colleague from Rhode Island came in here because I was going to pick up on something that he brought up the other day that I think is very important. We were talking about Basel II.

He asked—and I have the transcript here at the hearing where Chairman Bernanke was here. And I will quote, can I quote you?

Senator REED. Yes.

Senator SHELBY. In fact—and I will quote the record. This is Senator Reed, in addressing this to Chairman Bernanke: “It has been reported that Northern Rock—” which you are all familiar with “—the British banking institution that failed, that has now been nationalized by the British government was able to lower their risk-weighted assets by 44 percent under Basel II. The CEO of Northern Rock, at that time, described it as the benefits of Basel.”

This is, again, the words of Senator Reed, my colleague. And I suspect he is not describing it as that certainly—the Prime Minister is not describing it as the benefits of Basel now.

You know, we were talking about models and liquidity and capital and everything. One of my concerns about Basel II, and I have talked to all of you about it, is that a lot of the banks wanted—including some of our banks—wanted to lower their capital.

I know they want to create risk models to better use their capital. You want them to do this. We do, too.

But I have said this many times up here in this Committee, I do not know of any financial institution that is well capitalized, and well regulated, and well managed that has ever gone under. You know, I appreciate my colleague from Rhode Island raising this issue.

Is that a concern of all of you, dealing with Basel II, as you go through the regulations working together to make this work? It is of mine, sitting up here on the Banking Committee.

Governor Kohn.

Mr. KOHN. I think we have put a number of safeguards into place to avoid the kinds of outcomes that you are concerned about and that concern us, as well. We have a leverage ratio in place to put a minimum level of capital in there. We have oversight under Pillar 2 over the general capital levels of the institutions and can raise them if we think they are inadequate. There is a phase-in period of 3 years and we have agreed to take a hard look at the end of the third year and we will be looking at it constantly as we go through to see what the effects are.

I completely agree with you, Senator, banks that are well capitalized, well managed do not fail. And it is our responsibility to make sure that what we put in place strengthens the capital and strengthens the management. And that is what we are determined to do.

Senator SHELBY. Chairman Bair, do you have any comment?

Ms. BAIR. Yes, I share your passion for capital.

Senator SHELBY. Since you have the funds to bail out anybody, I think you will guard those zealously. Go ahead.

Ms. BAIR. Yes, we share your passion for capital. It is our main line of defense against bank insolvencies, absolutely.

And again, I think having clear transparent standards not only help assure that we have well-capitalized banks but also help address competitive disparities that might arise if you have more subjective standards.

So I think we are taking a very slow, cautious approach to implementation of Basel II. We are also going to be proceeding with the standardized approach under Basel II, which is much more like the current risk-based framework but more granular.

And so I think over this transition period we will work together to come up with the right result. But I could not agree with you more, this should not be about lowering capital.

Senator SHELBY. John.

Mr. DUGAN. I guess I would say 2 things. One, just to come back to the point that the losses that we have seen really have been in a Basel I world, even with respect to Europe because they really were not on the system until this year.

I think Basel II has many things in it that will improve risk management and regulation and supervision. You are absolutely right, it is not perfect, and it has the safeguards that we have.

Senator SHELBY. But there is no substitute for capital, is there?

Mr. DUGAN. There absolutely is no substitute for capital. But you want to have enough of it and you want to have it reflect risk. And if you are taking a lot of risk, you want more capital in the system. And so I think that is absolutely critical.

That is the point of Basel II. And if we get it wrong, then we will have not enough capital for the risk we are taking. But if we get it right, the more risk we have, the more capital it will have.

That is what we should be striving to get to, in my opinion. And I think we are making strides to go down that path.

The only other thing I will say about the Northern Rock situation, to be perfectly honest, is the big problem they had was a liquidity problem because they did not have a deposit insurance system in the U.K. like ours, and they had an old-fashioned bank run. And as I said many times——

Senator SHELBY. First time in 100 years.

Mr. DUGAN. That is right. We have a lot of problems in our bank system, but one thing we know how to deal with——

Senator SHELBY. 150 years

Mr. DUGAN [continuing]. Is failing banks. We know a lot about how to deal with failing banks, sadly. And so we tend not to have bank runs, even though we have more failing banks, because we have a quite well-developed deposit insurance system that makes people confident that even if their bank fails their deposits will be safe. That is a bedrock of our system.

Senator SHELBY. John, you oversee a lot of our smaller banks. Capital is important, is it not? Management is important. Risks are important. We understand all of that.

Do you have anything to add to this?

Mr. REICH. Well, I said earlier, Senator Shelby, I think you were not in the room, that when I started my banking career 46 years ago that I grew up in a generation of bankers who believe that you cannot have too much capital and you cannot have too much in your loan loss reserves. One of my concerns that I think today's environment is highlighting is the fact that some of our institutions may be challenged to raise their loan loss reserves as high as they should be because of SEC and accounting rules that do not give them as much flexibility as I think they need.

Senator SHELBY. Can I ask one last question, Mr. Chairman? I appreciate your indulgence.

Getting back to the rating agencies—and Senator Schumer, I think, raised some important questions here.

We are all troubled, as you are, by the faulty inadequate—gosh, ratings. And now all the downgrades. You know all the other. What went up is coming down, as we all know it does.

And some of the rating people have told me at times, well, they just give an opinion. You know, free speech, so to speak.

My gosh, you know, that opinion—one, it is paid for, I believe by the wrong people. Second, it is relied upon not only by people who invest but a lot of our institutions that you regulate can hold investment grade securities.

So we have got a circle here and I do not know how to break it. And I know you cannot legislate ethics. But you can put some things in place that will cut out a lot of obvious conflicts. That is a problem for us, I know, and also perhaps a problem for you, as regulators.

Mr. KOHN. I think there is 2 things we can do to ameliorate the situation. One is to insist that our institutions place less reliance on the credit ratings and look at the underlying. But second is to push those credit rating agencies to reform as much as they possibly can and to do a better job and to push them to note that structured finance is different from other kinds of things. And to make sure that the purchasers of structured finance—not only banks, but pension funds, whatever. I think a lot of folks looked at the AAA and said it is as good as a AAA bond. And it was not.

It is a very different instrument in which you are adding together a whole bunch of different loans. You get rid of the risk of individual loans to some extent, but you increase the risk that if the whole economy moves, the whole package of loans will move down together. And that is what happened there. And I think the purchasers did not recognize that risk, and the credit rating agencies did not do a good job of warning people.

Senator SHELBY. Thank you. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

I just, on this point before turning to Senator Reed—and I know a couple of you have to get going. We have been here a long time.

But Senator Shelby pointed out, when we were here in the S&L, we were talking about 1,000 banks in the S&L crisis. We are talking here, at least some numbers talk about—we are talking about foreclosure rates—but as many as 44 to 50 million homes could be adversely affected.

We are looking at prices dropping. When prices drop, values drop. When foreclosures occur, values drop of otherwise people who are very current in their obligations. Crime rates go up actually 2 percent in neighborhoods where that occurs.

There is some significant and profound implications of all of this. And 1,000 banks is one thing. Talking about this issue makes that problem pale, in many ways. $150 billion bailout was not insignificant but the payer of last resort is the American taxpayer in all of this. And so while others may have been complacent and so forth and looking around, the American taxpayer pays an awful price for this if we do not get this right.

And so I want to underscore the points that have been raised, and just to say—and I have got a couple of other questions and I will come back after Senator Reed. But that whole idea that you are the cops. You are the ones that are on the beat here, so to speak. When cops are not on the beat, they are not watching it and keeping an eye on it here, we end up where we are to a large extent.

So I want to come back, as I say, in a few days we are all studying all of this. But I want some more specific answers on what we are going to do, what you are going to do, what the institutions have to do.

Jack, let me turn to you.

Senator REED. Well, thank you, Mr. Chairman. And thank you again for your excellent today.

Senator Shelby pointed out some concerns about Basel II that I expressed previously. But there is another concern, and that is sometimes I get the impression that we are not searching collectively with our global colleagues for the best regulatory system. We are responding to competitive pressures, perceptions within our banking community that there is much more flexibility overseas and if we do not move down that Basel road we are going to be left behind, we are going to see financial institutions redeploy to London, to elsewhere in the globe.

And here again, the analogy of the regulator, the policeman, whatever, is that I think you have a special role to play to ensure that these competitive pressures, which are very powerful for financial institutions who are lobbying you prodigiously on these new rules, do not overwhelm sound regulatory practice in terms of capital ratios and all the other aspects.

So that is another concern which I do not think is articulated enough, but it is a reality. People come in to see us and they can talk about ratios and capital levels and everything else. But they are afraid of being left behind in a global race, which I hope is not to the bottom. And your role is to prevent it from going in that direction.

I was struck at your testimony, Governor Kohn. You talked about recent events indicate that bank management, in many cases, was not fully aware of the latent risk contained in various structures and financial instruments. Which raises a question which Senator Shelby raised—and I will raise it slightly different. To what extent did the Federal Reserve understand those latent risks? To what extent you should have done it earlier? To what extent—and this might be the perennial question of any regulator—you should have substituted your judgment for the judgment of very talented, very intelligent, and extremely well compensated individuals?

Can you address that?

Mr. KOHN. I think these are all questions we are asking ourselves, Senator, and I do not have definitive answers to them. I think we did recognize the risk, in a general way, somewhat better than the banks did. We tried to warn people in speeches and in conversations that we thought that they were taking risks and not being appropriately rewarded for them or controlling them. We tried to work with the banks.

But I think it is quite possible that we could have been more forceful. We probably did not recognize it to the extent that it ended up existing. These are very unusual events. There are no excuses here. But I think it would have been hard to see a year ago where we are today. But that does not mean that both the Federal Reserve and the institutions that regulate should not have been taking steps to ensure against the remote possibility of a very adverse event. And it is obvious that we did not.

Senator REED. Well, I think that is a very candid and a very sincere response. In your reflection, which you are doing now—and I suspect you are—you have to ask some questions about the culture of regulation at the Fed. Because you pointed out how you communicate, through speeches, through sitting down and sort of having conversations with your regulated institutions. That might not be the most effective way to make a point when there is literally billions of dollars at stake if they pursue a policy that they judge might be prudent and you judge reckless and you are trying to discuss it. So I know you are going to reflect on that respect.

Mr. Dugan, you had a comment?

Mr. DUGAN. Yes, if I could just add, I would say a couple of things. One, I do think that we were very much aware of the loosening of underwriting standards in the subprime market, and we spoke out about it. We had had some very bad experiences at the OCC with national banks and subprime loans, not so much in mortgages but in other places. And we were very reluctant to allow a lot of subprime lending, mortgage lending, to go on in the institutions we supervised. And as a result, there was not as much of it by a long shot being originated inside not just national banks but state and national banks.

I think a lot more of the looser part of it was in entities completely outside the banking system, that went to Wall Street.

Senator REED. But were your banks buying this paper?

Mr. DUGAN. That is going to get to the second part.

So then I think you look at where were we with respect to the things that have caused the biggest losses. And that is the speech that I was talking about that Senator Shelby referred to.

This stuff got packaged into some very complex instruments and then got rated according to super senior tranches, that got very high ratings, and then lower ratings.

The normal way any of us would look at that, is to look at the more risky tranches and pay more attention to them, and pay less attention to the least risky tranches.

And I think it is fair to say that bank management, the most sophisticated people among the bank structurers and the bank regulators, were lulled into a sense of complacency by these very high ratings. In fact, the AAA rated asset-backed CDOs are the thing that really needs the focus because, as Governor Kohn said, they behaved differently. AAA ended up meaning something very different in that context than they meant elsewhere. And I think that is one of the places we need to focus.

I also think that we ought to be careful about not throwing all credit ratings out. It is true that a lot of what we do focuses on credit ratings. But in a lot of ways, including the standardized approach that Chairman Bair was talking about, we are very focused on credit ratings.

The part that really caused the big huge losses was the super senior tranches of ABS, of subprime related collateralized debt obligations. And that is what we really need to focus on, on how that is treated, how it is rated, what kind of capital applies to it.

And the last point I will make is that we could have done a better job—and the banks certainly could have done a better job. Even though this was thought to be a relatively risk-free instrument, some institutions piled a ton of it up on their balance sheet and made a real concentration.

Others just abided by the notion that they were not going to put as many of their eggs into that one basket. And that very simple principle about concentration risk is what caused the really big losses, not just at commercial banks but at investment banks and foreign banks. And that is a basic principle that we have to look at in the risk management when we come back to some of the things that you were talking about, Senator.

Senator REED. Thank you. Let me make, if I may, 2 brief points and then yield back. One is that last April, at the request of Senator Dodd, I chaired a hearing on the merging subprime crisis. I think some might have been here in attendance.

But the problem then was $19 billion worldwide. It is now $160 billion, growing to $400 billion or $600 billion. One of the things that struck reading about Hope Now is that most of the relief that has been provided so far is to conventional mortgage holders, the best credit risk. The real problem that is facing us is when these alternates and subprimes start resetting, which is beginning. But we have not reached the middle of it yet.

So we are looking at a wave that is coming toward us, not one that has passed by us. I think that has to strengthen or focus our options.

The second point that Governor Kohn made is about one of the presumptions—it was not jut financial institutions, it was everybody in this country—housing prices are always going up. I ask you, we have evidence now that that assumption is invalid.

But if that was the fundamental assumption that was motivating homeowners, lenders, everyone, we have to move I think much more aggressively to reinforce or reestablish that assumption; i.e., that housing prices will not decline precipitously.

It goes back to what Senator Dodd is talking about. Until we really aggressively and quickly shore up the housing values in this country, the basic assumption that we have operated with, everybody, for the last decade or more, maybe 50 years, has formed all sorts of economic decisions from the sublime, the intricate securitizations, to whether your child is going to be able to afford college because you can borrow from your house.

If we do not stop this decline quickly—and that is why I think Hope Now is not effective, it is just not face enough—we are going to see more pain and it is going to get worse and it is going to accelerate and will probably reach and maybe exceed that $600 billion mark, which would be unfortunate.

Thank you.

Chairman DODD. Thank you, Jack, very, very much. You have said the point eloquently here. That is why there is a sense of urgency about this because, as you all point out here, the implications of this now, the domino effect of this is obviously going beyond just the housing issue here. It is affecting so much more.

Senator Carper.

Senator CARPER. Thanks. You all have been very generous with your time and this has been, I think, an uncommonly good hearing, helpful for me and I suspect for my colleagues, as well.

Chairman DODD. All hearings in this Committee are all uncommonly good.

Senator CARPER. I can think of many one or 2 in the last 8 years that did not quite rise to that standard, but this has been uncommonly good.

I want to thank you for walking me through the housing recovery package and some of the proposed amendments to it. I realize you are operating with less than full knowledge about some of the provisions, so thank you for bearing with me. You provided some real constructive comments to us.

Two or 3 weeks ago Secretary Paulson was before us. The question I asked of him on housing recovery package, what are the Administration's priorities. He said the first priority, GSE regulatory reform. Second priority, FHA modernization. The third priority is this piece where we allow housing finance agencies to issue bonds for refinancing. Those are his top three priorities.

The Chairman and the Ranking Member have been working and their staffs have been working to try to get this to closure with the House of Representatives on FHA modernization. My hope is that we are almost there.

The third element that I mentioned in the administration's priorities, there seems to be agreement, bipartisan agreement between the legislative and the executive branch.

That leaves us with the third being GSE regulatory reform, and the last time—it has been a couple of years since we actually—and we have had a hearing on it this year, but we actually voted on this stuff about—what was it? Two years ago, I think. And we ended up taking pretty much a party line vote, as I recall. It is something that we do not oftentimes do here. But we were unable to come to a consensus, and if we do not have consensus on an issue like that, it is hard to get floor time, and we just do not legislate in the full Senate.

There is going to be a hearing—the Chairman has set it as a priority, one of his early priorities for this year—to finish our work on GSE regulatory reform. And toward that end, we have another hearing that is scheduled for this Thursday. You all are not going to be there, but you are here today. And I am just going to ask you to give us some advice as we prepare hopefully to move to mark up legislation on providing regulatory reform for our GSEs.

There is actually a fair amount that we agree on today that we did not a couple of years ago, and I will mention some of the elements of agreement we agree on: combining OFHEO and the Federal Finance Board; we agree on the need for the independence of the regulator from the appropriations process. We agree on independent litigation authority for the regulator. Currently, I think they have to go through the Department of Justice for that authority. We agree on right of receivership to place these entities in receivership if that is deemed appropriate. We agree on combining the mission oversight and the new product authority under one world-class regulator. We did not always agree on that. We agree on the need for flexibility for the regulator to set capital standards. And I believe we agree on some restrictions on the size of the GSE portfolios. Those are pretty much the areas I think on—some of the areas, major areas on which we have agreement now.

Would you have any advice to us, as we hopefully prepare to move on to actually introduce legislation and begin marking up it, on GSE regulatory reform? The elements that I have mentioned I think are pretty much common knowledge. Are any of those that are especially important? Are there other things that we should be focused on as we take up our work?

Ms. BAIR. I used to work at Treasury when GSE reform started. I think the health, the safety, the stability of the GSEs is extremely important, especially in times like these when you have more and more mortgages becoming distressed, and they may be called upon increasingly to fulfill their guarantees. So I think it is very important, and I am encouraged by all the areas of agreement, and I would hope it could get done.

I would also just add editorially that I would hope the GSEs, especially Fannie and Freddie, could take a more proactive role in supporting loan modifications as huge holders, portfolio holders, of mortgages, as well as those who hold substantial amounts of MBS. I think as major investors as well as their role as GSEs could play a very instrumental role in getting the market moving even more aggressively to modify loans. And I know there are aspects of the pooling and servicing agreements that impact conforming loans that may be an issue. But I would hope that that could be worked out, and that might also be something you would want to take a look at.

Senator CARPER. Great. Thanks very much.

Mr. Dugan.

Mr. DUGAN. Generally, I think that the focus on the safety and soundness side is the part that we would stress—I think it is in the interests of the GSEs and of all parties to get comprehensive reform passed that provides a strong supervisory structure like what we have with the Federal bank regulators. Without going into all the details, I think that is really the kind of fundamental issue to get right, particularly, as we are in this period where all their assets are mortgages based on house prices. There are significant credit issues and other issues there, and you want to make sure you have a regulatory structure that is up for that task. I think it is important to get this right.

Senator CARPER. All right. Thank you.

Mr. Reich.

Mr. REICH. I do not know that I have anything substantive to add to that. You obviously have a number of areas that you agree on. I am supportive personally of all of the areas that the two parties are in agreement with, and I am hopeful that you will pass a bill.

Senator CARPER. All right. Thank you.

Ms. Johnson, anything you would like to add?

Ms. JOHNSON. Nothing additional to add. Just to say good luck.

Senator CARPER. Thanks. We might need it.

Governor.

Mr. KOHN. I think that it is very, very important that you reach agreement and get this done. I think the GSEs, as Chairman Bair was saying, could play an important role in helping the recovery of the housing market. But I would be very hesitant to see them greatly expand their role without appropriate and proper supervision, and of the nature, as Comptroller Dugan was saying, of the sort of oversight that the bank regulatory agencies have over commercial banks to protect the safety and soundness of those institutions if they were to expand. I think getting this done could build confidence in those institutions, and putting a structure in place in which they can expand, raise capital and expand, would be a very constructive step.

Senator CARPER. Thank you, sir.

Mr. GRONSTAL. To the extent that debt issued by the Government-sponsored enterprises is part of the broader capital markets, it is important that we improve the transparency there so that we can improve the confidence of the investors in our entire capital market system, because that is a big piece of the problem.

Senator CARPER. All right. Thanks.

Mr. Chairman, thanks for letting me get that question. I would just say, Mr. Chairman, in closing, I know an idea that you have been fleshing out focuses on these mortgages underwater or upside down, and the ideas that Mr. Reich has outlined and noodling with for, I think, to good effect in the last several weeks, I think there is a lot of promise——

Chairman DODD. I commended Mr. Reich about that. I did not agree with him on everything, but I commended him. And let me just say on the GSE issue, again, you know, there were those who had ideas on GSEs at Fannie and Freddie back a couple of years ago; had they been adopted, this problem would be a lot worse today. A strong regulator is absolutely essential. All of us agree on that here. I am determined to get a bill done, but I want to make sure we do it right as well. The idea there is a 30-year or 40-year fixed-rate mortgage in this country, which is unique in the world, exists because of Fannie Mae and Freddie Mac. And the idea that some are brought to the table on the issue I think would do us some real damage. But I am interested in getting a bill done here. We will get that done, too.

Senator SHELBY. Mr. Chairman?

Chairman DODD. Yes.

Senator SHELBY. I have to add a few things.

We are all, I hope, interested in GSE reform, but I believe that we have to take into consideration the thin capital structure of the GSEs, the systemic risk to the taxpayer, the product approval and so forth. I believe the GSEs have served a good purpose, but we want them to continue to serve a good purpose, and we do not want to, I believe, hopefully, to put the taxpayer at risk on all this. And I do believe they need a strong regulator, and they need somebody who is going to talk to them about capital, too.

I think we had a strong bill several years ago. Obviously, they had a stronger lobby than our strong bill.

Thank you, Mr. Chairman.

Chairman DODD. Let me raise one other question here, and, again, I am deeply appreciative of the time here. But this credit default swap issue is one that is lurking here that requires some comment, I think, before we complete.

According to some recent reports, the potential exposure of our financial institutions to losses from credit default swaps on collateralized debt obligations backed by subprime collateral could be significant. The New York Times reported late last month that the top 25 commercial banks held credit default swaps, some including subprime collateral, worth $14 trillion. American International Group, AIG, reported last week that it had lost $5.3 billion in the fourth quarter of last year doing par to a $15.5 billion write-down based on insurance the company had written for these CDOs. AIG's experience is only the latest example of some trends to downgrades and write-downs related to these derivatives.

I would just ask each of you here, in the course of examinations, how did the bank regulators review the valuation of significant assets such as CDOS in determining an institution's capital adequacy? And did the regulators perform an independent analysis of the value booked by the institution, or did it routinely accept the valuation of complex major assets? Governor Kohn.

Mr. KOHN. The truth is I do not know the answer to whether we did our own independent evaluation of those things. I know that we valued the risk management systems and whether things were being marked to market and whether there was collateral behind the changing values, so that whether the banks were protecting themselves if the value of the CDS changed and they were collecting the margin for that. And I believe they are.

So I think we looked at how the banks were protecting themselves and managing that risk. I do not know whether we did independent valuations—I question whether we would do independent valuations. As long as the risk management systems are in place, that is probably not necessary. But I do not know the——

Chairman DODD. Are you concerned, is the Fed watching this credit default swap issue?

Mr. KOHN. Yes.

Chairman DODD. It is a very technical issue and one that—I have sat and listened to people at some length talk about it and how it works and how these things get sliced and diced down the line, and then at the end of that line, who actually owns the policy——

Mr. KOHN. Right, and I think it——

Chairman DODD. Someone has got to know that, though. This is——

Mr. KOHN. But in one sense, I believe the New York Times article was misleading because it implied that someone could trade—a counterparty could trade, and you would have a new counterparty, and the first person who may be purchased—if Person A purchased from Person B, Person B could transfer that to Person C without telling Person A. That is not true.

Chairman DODD. Well, I tell you, I am not going to talk about who, but I sat with a major figure at a major private investment house who said that is exactly how it works.

Mr. KOHN. No, they cannot——

Chairman DODD. That is exactly what happens. I mean, I——

Mr. KOHN. Well, that is not the way the market is supposed to work, and I do not believe that is the way the market works for the most part. There was a problem in that regard several years ago, and the Federal Reserve Bank of New York, working with the entities in the market, got together and said this business of assigning this liability without notifying the person was not acceptable, and the market agreed and that practice has been stopped.

Chairman DODD. John, do you want to comment on this?

Mr. DUGAN. Yes, I would say a couple of things. We also participated in that exercise, which really was about the mechanics of how these worked, because it is quite complicated, how they clear, how they settle. I think there are a couple things to bear in mind.

No. 1 is that the notional values are huge, but they are a little misleading. Generally, banks tend to run, not perfectly, matched books that offset one position with another kind of position. They do not typically use it to offset their own credit risk positions. That is a very important point in how these things are structured.

There are certain kinds of credit default swaps that involve so-called correlation and hybrid risk types of products where there are more risks involved in that, and we do pay a significant amount of attention to it.

There are also still some mechanical issues about when you have more credit default swaps out than you have underlying bonds that you are using as a reference in how they are settled. This is an issue that has been raised by a number of people, both in the private and public sectors, as something that does need to be resolved over time. And the New York Fed and others have been paying a great deal of attention to it, but it is very much on the radar screen of the regulators as we look at this very important part of the market that has developed over the years. It is a very important part of our supervisory strategy.

Chairman DODD. Is it something we ought to be more concerned about than we are?

Mr. DUGAN. I think that you are appropriately asking questions about it and monitoring the situation, and we are doing the same. But I do not think it is something that we are suggesting in any way is setting off alarm bells.

Chairman DODD. OK. Sheila, do you want to comment on this?

Ms. BAIR. Well, a couple of things. The good news about this is that the exposure is concentrated mostly in the very large institutions, but the 5,200 banks that we regulate virtually have no exposure to this market at all.

I think it is also an example of where the monolines, like the rating agencies, got into an area that they really did not understand and were being a counterparty to transactions that they did not really understand, and then people relied on their AAA credit rating. So I think it all intertwines and cascades back on us.

So I think there may be further write-downs because of this. I do not really know. But I think based on the numbers we have been able to generate working with the primary regulators, this is something that the banks can absorb if it happens, and, again, it is concentrated in the very large institutions.

Chairman DODD. Yes, I am sorry. Go ahead.

Ms. JOHNSON. I would just like to add that only 2 out of 28 of our corporate credit unions invest in CDOs, and it is a very small part of their investment portfolio, less than 1 percent of the total investments. But we have stepped up our monitoring and stress-testing, and currently they are performing well.

Chairman DODD. I said the last question. Just if any one of you here could comment on this, we went through this issue back a few years ago with FASB during the Sarbanes-Oxley effort here, coming up with a different way. A lot of the same questions being raised about the credit rating agencies were raised about FASB, some of the inherent conflicts.

Does the FASB model that we ended up adopting here have any—does that have any relevancy to this question of the credit rating agencies in terms of a resolution of that in your mind? Or is it just so different in terms of how FASB operates and how—I mean, obviously they are very different entities. But it occurred to me there we ended up with FASB. Originally, as you will recall, it was totally financed by the very people, obviously, that were helping their accounting, so the inherent conflict, we changed that. Obviously, it is a public entity in a sense, as opposed to a credit rating agency. But any value of examining that as a comparison? You are saying no.

Mr. KOHN. I am saying I do not know, actually.

Chairman DODD. John.

Mr. DUGAN. I really do not know. I have never looked at it. It is an SEC type question as an oversight.

Ms. BAIR. I think it is probably working pretty well as compared to other things. There may be other priorities we need to look at.

Chairman DODD. Richard.

Senator SHELBY. I just have an observation. You know, in accounting when you are doing an audit, you are looking for the truth as you understand it, the truth of the financial system that this company has. And if you are looking at a bank, you are a regulator, you are looking at their assets and liabilities and their risk and how they manage risk. Do they have enough capital or have they really bitten off a lot more than they can chew and swallow?

FASB has certain accounting rules, and I know they are different from what you have to deal with every day. But somebody has to understand these financial instruments. And if you do not understand them—I am not saying you do not, but, you know, they are very complicated—who does understand them? And how do you regulate institutions that hold a lot of these instruments that have been sliced, diced, you know, here and there, without really understanding them, without understanding the risk on those books, so to speak?

I know it is a dicey proposition, but finance has moved down a road that very few people understand. But then it comes back to the fundamentals, and it is sitting in your lap now, and maybe the American people's lap, too. It is not nice.

Thank you.

Chairman DODD. Well, thank you. We have kept you a long time, but, again, I think you saw by the participation of the Members here on both sides the interest in the subject matter.

Tom, we appreciate very much the State perspective being here. It is a very valuable, added element in all of this, and I am grateful to you, Dr. Kohn, as well for coming, I know back and forth—we have had the Fed up here a lot over the last few weeks, and I am very sensitive to the idea that you have got a lot of other things to do other than just testify. But it means an awful lot to have all of you here.

As I said at the outset, I want to get back now—a lot of these hearings, it can end up in the ether, but I am very interested. I did not press this, John, but you talked about some of the forward thinking that you have had going on in your shop, and I want to see some of that forward thinking, how we are addressing these questions. This is really the nub of it. The questions raised in the Wall Street Journal this morning that Senator Bennett talked about in his opening comments are really at the heart of this. From our perspective here, obviously we watch what happens very carefully with the private institutions, but it is the regulators, including the State regulators, here who play such a critical role. You are the backstop. These are subject matters that very few people understand, including, I would say this respectfully, our colleagues here. Despite their good intentions to really understand the totality of all of this, not to have a stovepipe mentality about it, sort of looking at these things in sort of separate funnels, failing to recognize the interrelationships that occur here and how all of this is critically important to our economic success. But we count on you. That is where really this has to be. And Jack Reed's point here, the culture of how you approach your public responsibilities, your regulatory responsibilities, are critically important.

So I look forward to having you back here. We will work out schedules and times so it accommodates your busy schedules. But we are very grateful to you for your presence here today.

The Committee stands adjourned.

[Whereupon, at 1:31 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

EMBARGOED UNTIL DELIVERY

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

THE STATE OF THE BANKING INDUSTRY

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
U.S. SENATE

March 4, 2008
Room 534, Dirksen Senate Office Building

Chairman Dodd, Senator Shelby and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the condition of FDIC-insured depository institutions and the deposit insurance fund.

Last week, the FDIC released its *Quarterly Banking Profile*, a comprehensive summary of financial results for all FDIC-insured institutions for the fourth quarter of 2007.[1] Not surprisingly, the data in this report demonstrated that FDIC-insured institutions experienced significant declines in earnings and credit quality during the latter half of 2007, especially compared to the past several years of record performance. However, the vast majority of institutions remain well-capitalized, which will help them withstand the difficult challenges in 2008 until broader economic conditions improve.

While certain performance indicators -- including return on assets and the percentage of institutions reporting net losses -- were at levels that have not been seen since the early 1990s, recent industry financial results remain significantly better than the condition of the industry during that period. For example, the relative level of asset quality problems is considerably lower. At the end of 1991, 3.60 percent of all loans and leases were noncurrent compared to 1.39 percent at the end of 2007. The net charge-off rate in 1991 was 1.35 percent compared to 0.59 percent at the end of 2007. Another very significant difference between now and then is capital. At the end of 1991, the industry's risk-based and leverage capital ratios were 10.63 percent and 6.25 percent respectively; at the end of 2007, the risk-based capital ratio was 12.79 percent and the leverage capital

[1] See http://www2.fdic.gov/qbp/qbpSelect.asp?menuItem=QBP.

ratio was 7.98 percent. In 1991, there were more than 2,000 institutions that failed to meet the highest regulatory capital standard while fewer than 90 institutions were below this standard at the end of 2007. Perhaps the greatest difference between the early 1990s and today is the health of insured institutions. At the end of 1991, there were 1,430 institutions on the FDIC's "problem list" compared to 76 institutions at the end of 2007.

My testimony will review the financial performance of FDIC-insured institutions during the current period of economic uncertainty, highlight the risks to the industry going forward, and discuss the condition of the Deposit Insurance Fund. In addition, I will discuss the FDIC's actions to manage industry risks and address problems in the credit markets that affect insured institutions.

The Recent Financial Performance of FDIC-Insured Institutions

FDIC-insured institutions reported total industry earnings of $105 billion in 2007, down 27 percent from the previous year. The decline ended a string of six consecutive years in which industry net income set new records. More than half of all insured institutions reported lower profitability and 12 percent were unprofitable for the year. However, to put the decline in perspective, last year's earnings for the industry still surpassed the $100 billion mark for the sixth year in a row.

The earnings decline was most acute in the fourth quarter, when the industry earned just under $6 billion -- a 16-year low. It should be noted that the industry's earnings decline was concentrated among larger institutions. Six institutions accounted for half of the decline in earnings. Nevertheless, all of the institutions reporting the largest declines in earnings were well-capitalized at year-end 2007.

Much of the earnings decline stemmed from an increase in loan loss provisions, goodwill impairment expenses, and trading losses at large banks. In contrast, although earnings were down from previous periods at many community banks, they were more profitable as a group than large institutions in the fourth quarter. While industry return on assets (ROA) declined from 1.20 percent in fourth quarter 2006 to 0.18 percent in fourth quarter 2007, the average ROA at institutions with assets less than $1 billion fell from 1.03 percent to 0.74 percent. In addition, the balance sheets of community banks were healthier than larger institutions. At the end of 2007, the average percentage of loans that were 90 days or more past due or in non-accrual status at community banks was 1.21 percent compared to 1.42 percent at larger institutions.

The credit quality of banks' balance sheets deteriorated in 2007, reflecting weakness in the housing sector and disruptions to financial markets. The amount that banks set aside last year for expected loan losses equaled about 12 percent of net operating revenue, the highest proportion since 1992. In dollar terms, total industry loss provisions more than doubled to $68 billion. Net charge-offs were up year-over-year in all major loan categories except loans to the farm sector.

The decline in credit quality was most pronounced in the last three months of 2007. Total non-current loans rose by one-third during the fourth quarter to $110 billion. The increase was led by an $11 billion increase in noncurrent residential mortgage loans. At the end of 2007, almost 1.4 percent of all loans were non-current, while the non-current rate on residential mortgage loans reached a record high of over 2 percent.

Loss reserves at FDIC-insured institutions posted their largest increase in 20 years during the fourth quarter of 2007, but did not keep pace with the growth in noncurrent loans. The coverage ratio of reserves to noncurrent loans fell from $1.05 in reserves for every $1.00 of non-current loans to 93 cents during the fourth quarter. This is the first time since 1993 that the industry's non-current loans have exceeded its reserves. Because accounting rules require that loan loss allowances cover only probable losses, they do not permit banks to build reserves in a benign economic environment. As a result, bank reserves often must be significantly increased when there is a sharp turn in the credit cycle. As credit conditions continue to deteriorate, we are strongly encouraging institutions to increase reserves at a rate that keeps pace with institutions' projections for non-current loans. In the current environment, the attention banks have been giving to boosting reserves and capital needs to continue.

Although the industry faced significant challenges during the past year, the banking industry entered this difficult environment well-capitalized following years of record earnings. At the end of 2007, 99 percent of all insured institutions, representing more than 99 percent of total industry assets, met or exceeded the highest regulatory capital standard according to the statutory definitions under Prompt Corrective Action. This strong capital base is the result of a long and sustained favorable operating environment that has only recently deteriorated.

Certain elements of the current economic environment also are potentially favorable to the outlook for bank earnings. For example, history suggests that the recent decline in short term interest rates and the repricing of credit risk will help to improve net interest margins and boost net interest income over time, other things being equal. In certain situations, lower interest rates will also help to mitigate credit losses by reducing debt service costs to borrowers.

Credit Distress and Credit Disruption

The end of the historic boom in U.S. housing prices has contributed to credit market disruptions that continue to propagate through the financial system. Much of the disruption relates to uncertainty about the extent of the credit losses that will result from problem mortgage loans. Delinquency and foreclosure rates for subprime mortgages continue to rise. In third quarter 2007, over 16 percent of subprime mortgages were 30 days or more past due and 11 percent were seriously delinquent, meaning that the loans were 90 days or more past due or in the process of foreclosure.[2] During the third quarter, foreclosure was initiated in over 3 percent of almost 6 million subprime mortgages surveyed.

[2] Source: Mortgage Bankers Association's third quarter 2007 National Delinquency Survey.

Among conventional prime mortgages, over 3 percent were 30 days or more past due in third quarter 2007, and 1.3 percent of prime mortgages were seriously delinquent.[3] Both measures are at historical highs. Foreclosures started in third quarter 2007 represented 0.4 percent of over 35 million prime mortgage loans in the survey, almost double the rate of one year ago.

Credit distress in the U.S. mortgage securities market that emerged during the summer of 2007 has continued to worsen, with the most pronounced deterioration seen in recently originated loans. Serious delinquency rates on subprime mortgages securitized in 2006 are significantly higher than those for any of the previous three years. After a full year of seasoning, 12 percent of subprime loans securitized in 2006 were seriously delinquent, which is more than double the rate for loans securitized in 2005 and more than triple the rate for loans securitized in 2004.[4] Similarly, over 3 percent of Alt-A loans[5] securitized in 2006 were seriously delinquent after one year of seasoning, up from less than one percent for loans securitized in 2005. Preliminary data indicate that the serious delinquency rate for loans securitized in 2007 may eventually be higher than for the 2006 vintage.

Problems in the housing and mortgage markets have led to reductions in mortgage originations and securitizations. Subprime mortgage originations declined by 68 percent during 2007, and issuance of related mortgage-backed securities dropped by more than

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[3] *Ibid.*
[4] FDIC calculations based on data from Loan Performance Corporation.
[5] Alt-A loans are those made under expanded underwriting guidelines to borrowers with marginal to very good credit. Alt-A loans are riskier than prime loans due to the underwriting standards of the loans, not necessarily the credit quality of the borrowers.

half.[6] Origination of Alt-A mortgages fell by 31 percent during 2007, and issuance of related mortgage-backed securities declined by 32 percent. According to Merrill Lynch, no home equity loan securitizations have been issued since November 2007.[7]

The problems in the residential mortgage markets have spread to other credit markets and are limiting the flow of credit to other sectors of the economy. Among the reasons for this trend is a perceived lack of transparency in structured finance and a general over reliance on ratings and quantitative methods as a substitute for good judgment and traditional credit discipline. These two problems are closely linked -- if accepted market practice is to rely on a rating, then no reason exists for investors and other market participants to demand additional information about the collateral. The result of this mindset was the rapid growth of speculative markets for structured finance vehicles such as collateralized debt obligations (CDOs), driven by investors lacking the basic information necessary to make informed investment decisions.

The resulting shake-out in structured finance has caused CDO issuance to fall dramatically. Only $1.5 billion of CDOs were issued through mid-February 2008. At this pace, the 2008 annualized amount would be $12 billion compared to a total of $248 billion in 2007.[8] To date, Standard and Poor's has cut ratings on over 1,500 CDO tranches.[9] Many of the write-downs among the nation's largest banks in late 2007 and early 2008 were on CDOs. Some institutions have had to either allocate additional

[6] *Inside Mortgage Finance*, February 8, 2008, and *Inside MBS & ABS*, January 11, 2008
[7] Merrill Lynch, "Structured Finance - Market Update ABS," February 20, 2008.
[8] *Ibid.*
[9] "S&P Cuts Ratings On $6.75 Billion In CDO Tranches," *Wall Street Journal*, February 13, 2008.

capital against those assets or sell them. Some banks have brought CDOs onto their balance sheets, placing an additional burden on capital. Several institutional funds have had to suspend redemptions because of losses on CDOs.

The municipal bond market has recently become an area of concern, mainly due to the possible downgrade of the bond insurance companies. Nine of the largest companies insure about $2.5 trillion of domestic and international securities, about 60 percent of which are municipal bonds.[10] As the municipal bond market became more competitive in recent years, many bond insurers began insuring the highest rated tranches of structured finance products. As the lower tranches lost value, the bond insurers became increasingly exposed to credit risk and took major losses on their positions. Several bond insurance companies have been downgraded, which restricts their ability to insure municipal bonds. The Securities Industry and Financial Markets Association forecasts that the total municipal bond issuance will be $456 billion in 2008 -- a 5.4 percent decline from the record $482 billion issued in 2007. However, unlike the CDO market, underlying asset quality in the municipal bond market remains very strong overall.

Broader Economic Effects

The U.S. economy slowed markedly in fourth quarter 2007 in the face of the historic housing market downturn and ongoing credit market disruptions. Residential construction declined at an inflation-adjusted annual rate of 24 percent in the fourth

[10] See http://www.federalreserve.gov/newsevents/testimony/parkinson20080214a.htm

quarter, subtracting some 1.2 percentage points from net GDP growth. But virtually every other sector slowed as well, keeping net inflation-adjusted growth in GDP down to just 0.6 percent during the quarter. U.S. payroll employment shrank slightly in January for the first time in four and a half years, and the unemployment rate has risen by half a percentage point from its low in March of last year. Consensus forecasts call for the U.S. economy to grow by less than 2 percent in 2008, and most of the risk to this forecast appears to be on the downside.

Consumer spending, which accounts for over 70 percent of total economic activity, has slowed with the end of the housing boom. Prior to last year, large home price increases helped households extract hundreds of billions of dollars per year in equity from their homes, and consumer spending grew by more than 3 percent for three consecutive years starting in 2004. However, now the "wealth effect" from rising home prices is declining, helping to slow the pace of growth in consumer spending, and contributing to credit distress in consumer loan portfolios. Business investment also slowed in the fourth quarter in the face of slowing profit growth and uncertainty about the economic outlook. Spending on equipment and software grew at an annualized rate of just 1.6 percent for the year as a whole, the weakest performance since 2005.

Taken together, these trends point to a slower pace of economic activity in coming quarters that will have adverse effects on bank loan demand and credit performance. While the monetary and fiscal stimulus that has been undertaken to date will help to moderate this slowdown, it would be safe to characterize the operating environment of the banking industry during the coming year as one of significant challenge.

Risks to the Banking Industry

Construction and Development Loans

Given the current slowdown in financial and economic activity, the challenging bank environment of 2007 is expected to continue into 2008. One of the chief risks to the banking industry arises from an expected continued deterioration in the credit quality of construction and development (C&D) loans. The credit quality measures of these loans are now at levels not seen since the first half of the 1990s. For example, the percentage of C&D loans that are noncurrent increased to over 3 percent at year-end 2007 from less than one percent a year ago. Residential C&D lending is under the most stress, likely due to a decline in both home sales and home prices.

Although C&D loan growth has slowed across FDIC-insured institutions, concentration ratios continue to increase at community and mid-sized institutions, while leveling off at large institutions. The ratio of C&D loans to total risk-based capital ratio for the industry was 50 percent as of December 31, 2007, significantly above the 21 percent reported a decade ago.

The percentage of institutions that report C&D lending greater than 100 percent of total risk-based capital shows the extent of C&D loan concentrations among insured institutions. As of year-end 2007, close to 28 percent of FDIC-insured institutions reported C&D loans in excess of total risk-based capital. Just over half of mid-sized institutions reported C&D loan concentrations over 100 percent of total risk-based capital, while 26 percent of community institutions and 23 percent of large institutions reported C&D loans in excess of total risk-based capital.[11]

Commercial Real Estate

Upheavals that began in residential markets now affect commercial real estate capital markets, resulting in sharply curtailed liquidity. Commercial real estate prices rose rapidly during the past several years. However, as resale options have diminished, banks have shifted back to fundamentals and rental income is the main source of commercial real estate loan repayment. Securitizing commercial real estate loans has become difficult. After a record $234 billion in commercial mortgage-backed securities were issued in 2007,[12] January 2008 was the first month since at least 1995 in which no commercial mortgage-backed security issue came to market.

Commercial real estate loans at insured institutions are showing signs of deterioration at the same time that concentration levels are at or near record highs, particularly among small and mid-sized institutions. Over half of institutions with assets

[11] Community institutions in this context refers to institutions with less than $1 billion in total assets.
[12] See http://www.financialnews-us.com/?page=ushome&contentid=2449801639

between $1 billion and $10 billion have commercial real estate loan portfolios that exceed 300 percent of their capital, nearly double the share for institutions in this size range in 2000.[13] Similarly, the share of institutions with less than $1 billion in assets with commercial real estate concentrations exceeding 300 percent has almost doubled since 2000 to over 32 percent as of year-end 2007.

Mortgage Finance and Consumer Credit

The coming year could prove to be a transitional year for the performance and business models of institutions engaged in non-traditional mortgage lending, structured finance, and leveraged lending activities. Very large commercial banks and thrifts involved in these areas have been particularly hard hit. Loan originations are down and many institutions are holding loans that normally would have been sold. Some institutions have experienced strained capital and liquidity positions, but fortunately these institutions have so far been able to raise funds through borrowings, deposits, and capital infusions.

As mortgage credit problems have risen, households have increasingly turned to other forms of consumer credit. As of December 2007, consumer credit outstanding was over $2.5 trillion, up almost 6 percent over the prior year. This increase was driven largely by revolving credit, which climbed approximately 8 percent year-over-year to $943 billion. While the increase in mortgage debt has been slowing, revolving consumer

[13] Commercial real estate loans include real estate construction and development loans, loans secured by nonfarm nonresidential properties, loans secured by multifamily residential properties, and loans to finance commercial real estate, construction and land development activities that are not secured by real estate.

credit outstanding has been growing, particularly since 2006. This may be a result of tightened underwriting standards that have made it more difficult for people to borrow against their home equity, forcing them into higher-interest unsecured personal debt. Consumer loan performance peaked in first quarter 2006 due to factors such as strong job growth and strength in the housing sector. Since then, broader economic and financial conditions have weakened, causing delinquency rates to increase, although they currently remain low by historical standards.

The Condition of the Deposit Insurance Fund

The Deposit Insurance Fund (DIF) remains in a financially strong condition. The DIF balance grew during 2007 by 4.5 percent to $52.4 billion, up from a 3.2 percent increase in 2006. The higher rate of increase is attributable primarily to greater assessment revenue. The Federal Deposit Insurance Reform Act of 2005 permitted the FDIC to charge every insured institution a risk-based premium, but also provided one-time credits to many institutions that had paid high assessments to build up the insurance funds in the early to mid-1990s. In 2007, the DIF recognized $643 million in assessment revenue, a result of $3.7 billion in risk-based assessments charged, minus $3.1 billion in credits. By contrast, the DIF recognized only $32 million in assessment revenue in 2006. Assessment income is expected to rise in 2008 as institutions deplete their available credits.

From February 2007 through February 2008, four FDIC-insured institutions failed with total assets of $2.4 billion and estimated losses of $126 million. These were the first failures since June 2004. The DIF's contingent liability for probable and reasonably estimable losses from anticipated failures was $124 million at year-end 2007, with $1.7 billion in additional possible losses identified. The estimate was based on industry financial data for the third quarter of 2007 and supervisory information as of the end of the year -- the most current data available at the time of the issuance of the FDIC's 2007 financial statements. However, industry financial data for the fourth quarter that have only recently been released and new supervisory information indicate that losses from failures this year will be higher than the year-end 2007 contingent liability, and that higher losses may continue into 2009, while remaining within historical norms.

The number of failures in recent years has been unusually low by historic standards and it is reasonable to expect that bank failure activity in the near term will be more consistent with traditional levels. As of year-end 2007, the FDIC had 76 insured institutions with approximately $22 billion in assets on its problem bank list.[14] These are institutions that are subject to heightened supervisory attention due to their supervisory ratings. Although the number of institutions on the list increased from 2006, it currently is well below levels seen during previous economic downturns -- and most banks on the list ultimately do not fail.

[14] Federal regulators assign a composite rating to each financial institution, based upon an evaluation of financial and operational criteria. The rating is based on a scale of 1 to 5 in ascending order of supervisory concern. "Problem" institutions are those institutions with financial, operational, or managerial weaknesses that threaten their continued financial viability. Depending upon the degree of risk and supervisory concern, they are rated either a "4" or "5."

Although there were no bank failures in 2005 and 2006, rapid insured deposit growth in those years (7.4 percent and 6.8 percent, respectively) pushed down the DIF's reserve ratio -- the ratio of the fund balance to estimated insured deposits -- from 1.31 percent at year-end 2004 to 1.25 percent at year-end 2005 and 1.21 percent at the end of 2006. After declining to 1.20 percent in March 2007, the reserve ratio began to rise as insured deposit growth slowed and assessment revenue began to increase. The DIF reserve ratio ended 2007 at 1.22 percent, with insured deposits rising by 3.4 percent for the year. The DIF appears to be on track to reach the designated reserve ratio of 1.25 percent in 2009, in accordance with the FDIC Board's stated objective for the fund.

FDIC's Response to Industry Risks and Problems in the Credit Markets

The FDIC is moving proactively to manage industry risks and address problems in the credit markets that affect insured institutions. Restoring the function of credit markets will depend on improvements in disclosure and the elimination of moral hazards. We are focused on keeping families in their homes by encouraging mortgage loan modifications, directing supervisory efforts towards key areas of risk, strengthening lending standards, and enhancing disclosure and transparency in both the primary and secondary credit markets.

Subprime Mortgages

The FDIC has been working for many months to address issues surrounding subprime mortgages, especially the increasing volume of foreclosures. Institutions have been encouraged to work toward long-term sustainable and affordable payment obligations that will provide stability for servicers and investors as well as borrowers. I would again remind borrowers who are having difficulty making their payments -- or anticipate having difficulty making their monthly payments when their interest rate resets -- to contact their loan servicer directly as soon as possible to discuss options. I also would caution troubled borrowers to be careful in dealing with organizations that encourage borrowers to cease making payments or walk away from their home while also promising to repair their credit. If it sounds too good to be true, it may well be a scam that will damage the borrower's credit and increase their expenses. Working directly with the servicer or legitimate non-profit organizations is the best approach for troubled borrowers.

As I testified before this Committee last month, I proposed a systematic approach to addressing subprime adjustable rate mortgage loans for owner-occupied properties where the borrowers are current on their payments but will not be able to maintain the payments following the reset of their interest rates. For this group of borrowers, I have recommended that servicers take a systematic and streamlined approach to restructuring these loans into long-term, sustainable loans at the starter rate -- which is already above market rates for prime loans.

For other borrowers, by applying reasonable measures of the likelihood of default, such as commonly accepted debt-to-income ratios, servicers should quickly identify loans facing likely default, develop broad templates for restructuring these loans into long-term, sustainable loans with fixed rates for at least five years, and proactively initiate that process. In addition, in appropriate circumstances, lenders and servicers also should consider forgiving a portion of the principal balance owed. This would likely be the case where the home is owner-occupied, the borrower's current income cannot support repayment of the loan, and the net present value of reducing the principal to a sustainable level is greater than the anticipated net recovery that would result from a foreclosure. Investors should be pushing for these types of modifications. Given current market conditions, servicers who take no action and choose to rely on the traditional loan-by-loan process leading to foreclosure could run a risk of legal liability to investors for their failure to take steps to limit losses to the loan pool as a whole.

Some servicers continue to express concern about potential legal liability to investors for loan modification activity. We believe that servicers have significant flexibility to restructure loans under current law. Indeed, as previously indicated, there may be litigation risk in failing to modify troubled mortgages. However, to address these concerns, Congress could explicitly affirm that servicers have such legal authority and establish litigation safe harbors for responsible, systematic modifications.

Although many servicers have recognized the benefits of addressing problematic loans on a systematic basis, some have yet to demonstrate an aggressive effort to dramatically increase the pace of loan modifications. While loan modification activity is picking up, foreclosures remain unacceptably high. I am optimistic that loan modifications will continue to accelerate. At the same time, I recognize that additional action might be necessary to reduce foreclosures and prevent the housing market from "overshooting" as prices adjust downward

In spite of some encouraging signs that servicers are increasing the pace of loan modifications, some reports continue to show a great reliance by servicers on repayment plans. Repayment plans or brief deferrals of payments will not allow us to get past our current problems. They are analogous to "kicking the can down the road". In addition, we need more consistent, transparent reporting of loan modification activity. Just this week, the FDIC and other federal regulators are issuing a statement calling for all servicers and lenders to provide more detailed reporting on their efforts through the Hope Now Alliance. The FDIC similarly supports state efforts to gather reliable information on servicers' programs

Safety and Soundness of Financial Institutions

From a supervisory perspective, we expect 2008 to be a challenging year compared to the past few years. Experience has demonstrated that credit losses stemming from broad economic shocks can take time to fully manifest themselves in financial institutions. The FDIC will continue to closely monitor the direction of the economy, the changing condition of institutions, and managements' actions in response to these changes. The FDIC takes a risk focused approach to bank supervision and we are actively concentrating our attention and resources on the areas of greatest risks for the institutions we supervise.

To keep abreast of risks related to non-traditional mortgage products, examiners are analyzing the structure of these credits to determine the ability to repay under periods of market stress. Their analysis includes an assessment of disclosures, the ability to repay, financial exposure to recourse provisions in sale agreements and litigation, the sustainability of liquidity under stress scenarios, appropriate accrual of interest income and expenses (including provisions for losses) and the adequacy of capital.

The FDIC is particularly focused on the risks posed by concentrations of commercial real estate in many financial institutions. Examiners are emphasizing to banks the need for risk management systems commensurate with loan concentrations as outlined in the final interagency *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* issued in late 2006.

FDIC examiners also are closely monitoring institutions that have been impacted by the stress in the market, focusing on these institutions' ability to maintain earnings and funding and to appropriately value thinly-traded assets. Our examiners are evaluating the impact of strained interest margins and deteriorating credit quality on earnings. The

FDIC also is assessing the level of capital in institutions that have experienced deterioration in asset quality or an increase in off-balance-sheet exposures. This includes requiring institutions to raise capital, if necessary. Our examiners also are assessing valuation practices and techniques for thinly-traded assets. In cases where institutions do not address their risks appropriately, the FDIC is taking corrective action, including downgrading ratings, increasing deposit insurance assessments and taking enforcement actions when necessary.

Finally, as we take appropriate supervisory action to address the safety and soundness of the institutions we supervise, the FDIC will continue to promote consumer protection during this challenging period. Recent conditions in the mortgage industry have demonstrated that ensuring fair treatment of consumers is vital to a safe and sound financial industry. The FDIC supports strong national lending standards and will work closely with our fellow regulators to ensure that standards are established and enforced pursuant to the provisions of the Home Ownership Equity Protection Act (HOEPA). Our ultimate goal is to ensure that financial products are both beneficial to consumers and profitable to banks.

Conclusion

The banking industry is currently facing a number of challenges. The vast majority of FDIC-insured institutions remain well-capitalized as they face significant risks from economic conditions, the fallout from recent unsustainable mortgage lending practices and disruptions in the credit and capital markets. In response, the FDIC is focusing its attention on these risks to ensure that the institutions it supervises respond appropriately to maintain their safety and soundness. In addition, the FDIC is prepared to move promptly to handle any bank failures that may occur.

Longer term, there are lessons to be learned from the current economic situation that will prove beneficial for the financial industry. By returning to fundamentals, banks, including community banks, should have an opportunity to recapture market share from non-bank competitors as some credit market funding shifts from the secondary market to banks and thrifts. The industry and its customers also will benefit from an emphasis on proven standards and the importance of adequate capital. Less reliance on model driven risk assessment and a more judicious approach to using rating agency analyses will improve the functioning of the markets. Finally, increased transparency will ensure that all market participants better understand the products they are investing in and the risks they are accepting.

This concludes my testimony. I welcome any questions that the Committee might have.

For Release Upon Delivery
10 a.m., March 4, 2008

TESTIMONY OF

JOHN C. DUGAN

COMPTROLLER OF THE CURRENCY

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

MARCH 4, 2008

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Contents

I. Introduction

Chairman Dodd, Senator Shelby, and members of the Committee, I am pleased to be here today to testify on the condition of the banking system. As you know, the Office of the Comptroller of the Currency (OCC) charters, regulates, and supervises all national banks. At the end of 2007, there were 1709 banks in the national banking system, with total assets of $7.8 trillion; that is about one of every five banks in the United States, with 70 percent of all commercial banking assets. These include the country's largest, most complex banks, as well as many community banks, since almost 90 percent of national banks have less than $1 billion in assets.

In general, due to a long period of strong economic growth, exceptionally low credit losses, and strong capital ratios, the national banking system has been healthy and vibrant. Indeed, one simple measure of this fact is that we just went through the longest period in the 145-year history of the OCC without a single national bank failing: nearly four years.

Now, however, the system is being tested. Two powerful and related forces are exerting real stress on banks of all sizes and in many different parts of the country. One is the large and unprecedented series of credit market disruptions, still unfolding, that was precipitated by declining house prices and severe problems with subprime mortgages. The other is the slowdown in the economy, which has begun to generate a noticeable decline in credit quality in a number of asset classes. The combination of these forces has strained the resources of many of the national banks we regulate.

Despite these strains, the banking system remains fundamentally sound, in part because it entered this period of stress in such strong condition. Thus far national banks have been able to address a number of significant problems that have arisen while continuing to supply credit and other banking services to the U.S. economy – although there is no doubt that credit standards have tightened. For example, large banks provided liquidity support to asset-backed commercial paper conduits and structured investment vehicles or SIVs – often involving the painful recognition of losses – to restore more normal funding in these markets. Likewise, banks with concentrated positions in collateralized debt obligations backed by subprime asset-backed securities have recognized large losses – but have also raised large amounts of capital to offset these and other losses. And a large national bank holding company entered into an agreement to purchase the nation's largest mortgage originator, which had been under severe funding stress, and that action had a calming effect on the market.

Despite such efforts, however, significant market disruption issues remain to be addressed, such as the potential downgrades of monoline insurance companies; significant funding problems in the auction rate securities market; and severe constriction in the securitization markets for residential mortgage-backed securities, commercial mortgage-backed securities, and leveraged loans.

Likewise, the economic slowdown and problems in the housing market have caused banks to increase loan loss reserves significantly for such assets as residential construction and development loans; home equity loans; and credit card loans. Indeed, smaller banks that have exceptionally large concentrations in commercial real estate loans – and there are many of them – face real challenges in those parts of the country where real estate markets have slowed significantly. Unlike the unprecedented market disruptions of the last six months, these more traditional credit problems are familiar territory to bankers and supervisors. The key to addressing them is for bankers to recognize problems early and manage through them, and that is exactly what our examiners are working with them to do.

The body of my testimony today describes the current condition of the banking system using some of the traditional measures of condition such as profitability and capital. Because of the influence of a variety of complex forces that have been at work in the domestic and global financial systems over the last few years, I will take some time to describe those forces, to help put the current condition in context. However, a discussion of conditions should not focus solely on where we are, but also on where we are heading.

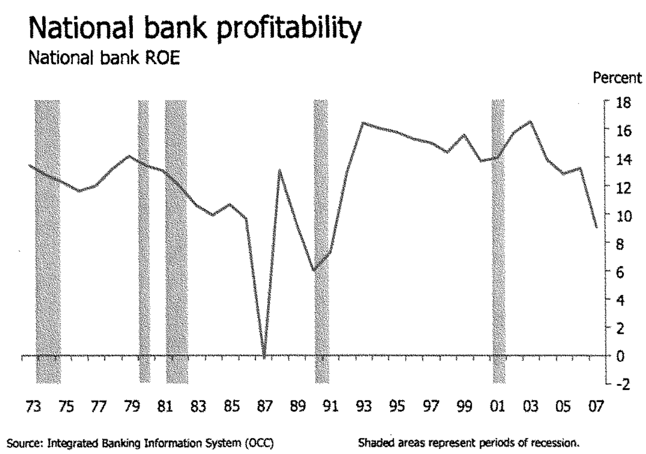
The banking system and its regulators face a number of significant challenges over the near term. The testimony therefore describes several of the more important of those challenges, and concludes with a discussion of how we see banks responding and how we, in turn, are responding.

Finally, your letter of invitation also asked us to describe our current efforts to address foreclosure prevention and mitigation efforts. This is a very important issue for the OCC since the largest national banks that we supervise act as servicers for about 40 percent of all mortgages issued in the United States, including a significant number of subprime mortgages. As the body of my testimony describes in more detail, the OCC has taken a number of steps to encourage national bank lenders and servicers to work constructively with borrowers to avoid foreclosure except when absolutely necessary. We have joined the other banking agencies in issuing guidance to that effect; we have strongly supported the efforts of the HOPE NOW alliance; and we have supported an amendment to the Community Reinvestment Act regulations that would provide CRA credit for foreclosure prevention activities in distressed middle-income neighborhoods. We also announced last week a significant new effort regarding the reporting of key data on mortgages, including mortgage modifications and restructurings: we are requiring our largest national bank servicers to provide standardized reports on a range of mortgage metrics, not just for subprime adjustable rate mortgages, but for *all* mortgages. These data, which are consistent with the HOPE NOW metrics, will provide an important way to track mortgage performance against a broad range of indicators.

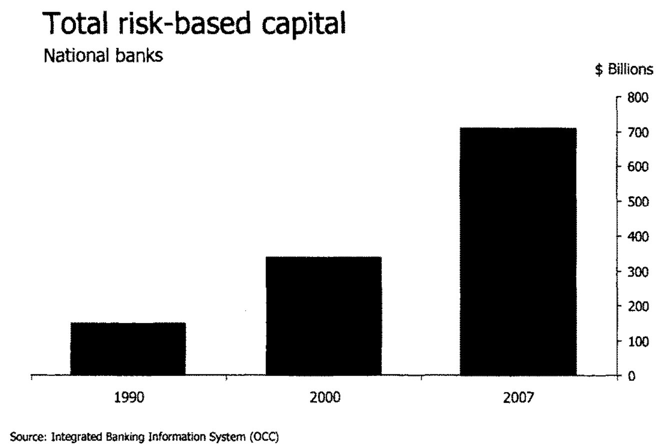
II. Condition of the National Banking System

A. A Period of Strength and Growth

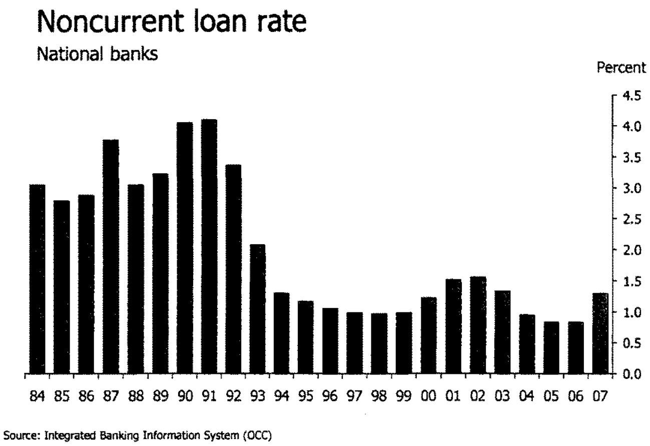
Until very recently, favorable economic conditions helped banks generate solid profits and consistent growth. The U.S. economy was performing well, the global economy was growing as fast as it had since the end of World War II, inflation remained under control, and liquidity was abundant. Between 1993 and 2007, annual return on equity for the national banking system averaged over 14 percent. To put that performance in perspective, the average for the twenty preceding years (1973 to 1992) was around 11 percent, with annual return on equity reaching 14 percent in only one of those earlier years.



Other measures showed the same favorable trends. Total assets in the national banking system have risen steadily for more than two decades, even as the number of banks has declined. And total capital has more than tripled over the last seventeen years, to roughly $700 billion, making the national banking system better-positioned to absorb shocks and losses. With the exception of a handful of relatively small banks, all national banks currently meet the regulatory definition of "well capitalized."



An exceptionally benign credit environment in recent years also contributed significantly to earnings. Problem loans in the national banking system fell for a decade, reaching historic lows, as illustrated in the accompanying chart. Although the share of noncurrent loans – the percentage of bank loans that were 90 days or more past due and on nonaccrual – has risen recently, it remains very low by historical standards. The low level of problem loans held down credit losses for national banks and contributed importantly to their earnings.



B. The Changing Financial Sector

While favorable economic trends helped produce a sound and healthy banking system, their influence on elements of the broader financial sector also helped set the stage for problems to follow. The combination of steady growth, abundant liquidity, and minimal losses led to relatively low yields on safe assets, and reduced the spreads on riskier assets as investor demand for new products that could deliver higher returns far outstripped supply. Increasingly, investors accepted greater risk in pursuit of their earnings goals. Hedge funds and private equity funds became more prominent during this period, expanding the range of activities and risk-taking in financial markets.

Concurrent with these developments, and to some degree fostered by them, the U.S. and many other countries experienced rapid home price appreciation. Liquidity provided by investors searching for high-yielding financial instruments helped support expanded use of various non-traditional mortgages. The securitization market helped facilitate strong mortgage loan growth, as nonconforming loans, including jumbo and subprime mortgages, came to account for an ever larger share of the market, with private issuers claiming more than half of the mortgage securitization market. Many of these same factors helped extend the market for U.S. assets to overseas investors.

These factors clearly affected the operations of national banks. Sustained economic expansion, particularly strength in housing, contributed to an acceleration of asset growth and to growth in bank earnings. Bank holdings of first mortgage, home equity, and construction loans all rose significantly. Other categories of lending also grew more rapidly to support business activity associated with the housing industry.

The impact of these developments varied across different segments of the banking industry. Larger banks had the capacity and supporting technologies for packaging pools of residential loans into mortgage-backed securities for sale to the investment community, and for managing the interest-rate risk of holding longer-term assets. As a result, residential mortgage loans at national banks with assets over $10 billion grew rapidly, reaching 36 percent of total loans by December 31, 2007, up from 22 percent in late 2000. Larger banks also experienced strong gains in noninterest income from residential mortgage securitization and servicing.

In contrast, residential mortgage lending declined as a share of loans at smaller banks. Smaller banks found it more and more difficult to compete with their larger counterparts in residential lending, and shifted toward lending for construction and commercial real estate. This was especially true in areas with vibrant housing markets, where home building was a key part of the regional economy. Construction and commercial real estate lending puts more of a premium on knowledge of individual borrowers and local market conditions; this tends to be a strong suit of smaller institutions. In addition, many large and small banks significantly increased their home equity loan portfolios, as consumers took advantage of home price appreciation to finance property improvements, purchase big-ticket durable goods, and pay down other forms of debt.

But banks also faced greater competition in lending, especially for home mortgages, as less risk-averse and less regulated players moved into residential lending. Increased competition and abundant liquidity kept pressure on risk spreads, squeezing banks' net interest margins to historic lows in 2007. These pressures led to loosened underwriting standards, as loan growth became ever more critical to earnings. This slippage in lending standards, while making credit much more widely available, ultimately resulted in over-leveraged borrowers, particularly in the area of subprime residential mortgages. When borrowers were unable or unwilling to perform, this led to substantial losses for lenders and investors and turmoil in the markets.

By 2005, as interest rates rose and affordability deteriorated, the housing sector began to show signs of weakness. Home price appreciation slowed, causing some speculative investors to sell, which put further pressure on home prices. By 2006, national average home prices had leveled off. Home building and sales, however, remained at very high levels through the first part of 2007. During this period, subprime mortgages, mostly originated by nonbanks, were a very important share of the total market. Many subprime mortgages were bundled into residential mortgage-backed securities (RMBS), and many of these RMBS were then repackaged into collateralized debt obligations (CDOs). Both subprime RMBS and CDOs backed by subprime RMBS were sold to a broad range of investors.

C. Recent Turmoil

In 2007, national median home prices fell for the first time in many decades. Many homeowners found themselves overextended, and foreclosures jumped to record levels. The effects were most pronounced and immediate in the subprime market, and resulted in numerous nonbank lenders being sold or forced out of business. The rapid expansion of the housing market had attracted new mortgage lenders and brokers, many of whom had only limited business experience or financial strength and operated with little regulatory oversight. Nonbanks were particularly active in subprime lending; indeed, national banks and their subsidiaries originated only about 10 percent of all subprime mortgages in 2006 (when underwriting standards were weakest).[1] Nonbanks expanded their market share in part by extending credit on considerably less stringent terms. They also popularized more risky types of mortgage instruments, which had the effect of expanding the pool of qualifying home buyers, but also reflected an abandonment of more traditional underwriting criteria. Loans originated by national banks tended to be more conservatively underwritten and structured, and their delinquency rates tend to be well below the national average.

Nonetheless, banks have not been immune to housing market forces. The impact of falling home prices and struggling borrowers has been evident in deterioration in the

[1] Although national banks were not dominant originators at the height of the subprime mortgage market, some continue to serve this segment of borrowers; with the exodus of many nonbank lenders and overall contraction of this market segment, it is likely that national banks' share of subprime mortgage originations is increasing.

residential real estate loans on the books of national banks. Noncurrent loan ratios increased in 2007 for each of the major categories of housing-related loans: one-to-four family residential mortgages, multifamily residential mortgages, and home equity loans.[2] National bank losses on home equity loans, for example, were more than three times higher in 2007 versus 2006, with most of it recognized in the fourth quarter; we expect bank losses from home equity loans to continue to escalate as, unlike first mortgages, these assets are predominantly held on banks' balance sheets.

States that saw a boom in home prices followed by a sudden slowdown have seen more rapid deterioration in loan quality, reflecting, perhaps, the significant role that speculators played in these markets. Among community banks supervised by the OCC, the noncurrent loan ratio for banks in the "boom-bust" states more than doubled to 1.4 percent last year, compared to 1.3 percent in economically stressed Midwest states, and 1.0 percent in the rest of the U.S.[3] The deterioration is now spreading to other nonresidential loan products like credit cards and auto loans.

The impact of these events in housing markets was rapidly transmitted to broader financial markets because many of the subprime mortgage loans have been securitized into the secondary market. Revelations about losses on subprime-related securities jolted investors during the second half of 2007. Several large financial institutions, including some with considerable experience in complex instruments, began reporting losses on CDOs and other securities backed by subprime mortgages, at the same time that more

[2] Noncurrent loan ratios increased by 83 basis points to 2.07 percent for one-to-four family; by 37 basis points to 1.03 percent for multifamily; and by 39 basis points to 0.80 percent for home equity loans. Noncurrent loans include those 90 days past due or on nonaccural; ratios are stated as a percent of the dollar value of loans in each respective loan category.

[3] Data are for national banks with assets less than $1 billion, excluding credit card and trust banks. "Boom-bust states" for this purpose are Arizona, California, Nevada, Florida, the District of Columbia, Maryland, and Virginia; "economically stressed" Midwest states for this purpose are Illinois, Indiana, Michigan, Minnesota, North Dakota, Ohio, South Dakota, and Wisconsin.

analysts were projecting sharp increases in mortgage defaults. Subprime-related losses have appeared in places market participants did not anticipate, including at foreign financial institutions. Lack of transparency has made it difficult to distinguish differences in risk among mortgage-related securities, and illiquid markets for many of these securities have made valuation difficult. Credit derivatives included in these products add leverage and amplify the risks.

One notable and unusual development has been the speed and extent of the fall in credit ratings for some previously highly rated subprime-linked securities. These declines have no precedent in recent history. For example, prior to 2007 no Aaa-rated corporate bond had been downgraded below A (a maximum of 6 notches) in a single step by Moody's. In contrast, among 198 Aaa-rated ABS CDO tranches downgraded by Moody's in October and early November, more than half of the downgrades exceeded 7 notches (Aaa to Baa1), and 30 were downgraded 10 or more notches to below-investment grade. One was downgraded 16 notches from Aaa to Caa1. As a result, the market value of these securities has dropped sharply and unexpectedly. These developments added to market uncertainty about mortgage-related assets, securitizations, and other structured products.

That market uncertainty has fed a general reduction in market liquidity. Liquidity problems particularly affected off-balance sheet conduits funded by short-term asset-backed commercial paper (ABCP), where the conduit held any kind of subprime mortgage-related asset (such as triple A-rated RMBS or CDOs). Due to the uncertain value of these assets, commercial paper investors began to lose confidence in the conduits and increasingly chose not to "roll over" maturing notes into new notes issued by the conduit. Bank sponsors of these conduits that were contractually bound to provide back-up liquidity were forced to take back on their balance sheets the subprime mortgage assets and sometimes other assets as well. The reduction in liquidity also had an even more pronounced effect on structured investment vehicles (SIVs) that held any subprime-related assets. Unlike traditional ABCP conduits, SIVs had very limited back-up liquidity contracts with their sponsoring banks. As investors became increasingly reluctant to fund these vehicles, some were liquidated, and in other cases, bank sponsors, even though they had no legal obligation to do so, absorbed SIV assets back on their balance sheets to avoid reputational damage.

In addition, turmoil in credit markets followed on the heels of a surge in leveraged buyout activity in early 2007. That resulted in a number of large banks keeping on their balance sheets leveraged loans that they originated with the intent to sell to investors; the banks also had a large volume of commitments that could not clear the market at prices they were willing to accept. Bankers made some progress in reducing the commitment pipeline; the largest national banks were able to reduce their volume of commitments awaiting syndication from $217 billion in July to $90 billion at the end of the year. However, as these commitments became funded and investor demand remained weak, banks ended up taking onto their books an additional $62 billion from the $127 billion funded during the second half of 2007, with a corresponding requirement for funding.

Late last year, liquidity pressures from all these events began to make some banks reluctant to lend to other banks, out of a desire to retain liquidity in such an uncertain environment. Lending terms shortened as the premium for longer-term debt rose substantially. To address this concern, the Federal Reserve and other central banks responded by injecting large amounts of liquidity into the global monetary system, restoring operations in key short-term markets and contributing to improvements in other markets as well.

Market liquidity for certain types of assets remains very constrained, however. For example, securitization channels for residential mortgages remain largely closed except for conforming mortgages sold to Fannie Mae and Freddie Mac. Banks have an additional significant source for mortgage funding liquidity in the Federal Home Loan Banks, which have substantially increased their advances, but overall there is clearly reduced liquidity in the nonconforming mortgage market. Similarly, the securitization channel has largely closed for commercial real estate loans that larger banks were packaging and distributing as commercial mortgage-backed securities (CMBS).

As recent earnings reports have shown, these factors significantly reduced bank earnings in the last half of the year. In fact, 2007 marked the first year-over-year drop in net income for the national banking system since 2000. The biggest single factor depressing bank earnings in the second half of 2007 was the recognition of large mark-to-market subprime-related losses on holdings of super-senior tranches of CDOs at some of the largest banks. As discussed above, these super-senior securities carried ratings that were widely understood to indicate very low risk. It is now clear that overreliance on these ratings provided by the major credit rating agencies played a significant role in lulling bank management, regulators, and others into a false sense of security. Some banks held large amounts of these assets on their books, in most cases regarding them as being nearly as safe as U.S. government debt for purposes of risk management. The large size of these positions – believed to be nearly risk-free – resulted in exceptionally large losses.

Larger banks also took significant write-downs on other assets on their books because of the financial market disruptions in the fourth quarter, including marks on the large pipeline of leveraged loans and loan commitments that were "stuck" on bank balance sheets. In addition, banks substantially increased provisioning for loan losses to reflect deterioration in credit quality in several categories of assets, including home equity loans and credit card loans.

Smaller banks also have been subject to earnings pressure. This has particularly been the case in areas where housing markets had seen rapid growth but are now experiencing a sharp drop-off. These problems have been compounded in some parts of the country by a weakening local economy and depressed loan demand. Many smaller banks also have experienced sharp increases in noncurrent loans, leading them to increase provisions for losses.

D. Banking System Response

Given this challenging environment, it is perhaps remarkable that banks have been able to expand lending even while absorbing additional assets and recognizing sizable losses. Lending growth has slowed, but not contracted, as some had feared. Some portion of the growth stems from dysfunction in other parts of the credit markets that has forced banks to take back on their balance sheets loans that they thought they had sold, or to keep on their balance sheet loans that they hoped to sell but could not. It is clear, however, that this is not the whole story, and that banks continue to perform in their key role as intermediaries. As of the end of 2007, growth has continued in most categories of lending, and loans have been growing at both small and large banks, even those that have had to unexpectedly fund additional assets as a result of financial market disruptions. There is also evidence that for most creditworthy borrowers the cost of funding has declined, as the sharp decline in the general level of interest rates has more than offset any increases due to heightened risk premiums. For example the prime rate, now at six percent, has fallen more than two full percentage points since early September.

Banks have been able to absorb financial shocks for a number of reasons. The first and most important is that, because they entered this period in overall good health, banks have had the earnings and capital to weather market downturns thus far. Despite large write-downs and a drop in income in the fourth quarter, the national banking system still generated almost $65 billion in net income in 2007. Capital levels well in excess of regulatory minimums gave banks the flexibility to add sizable quantities of assets to their balance sheets.

Banks have further strengthened their position by reducing dividends and issuing capital and debt in both public and private offerings. For example, nine of the largest banks regulated by the OCC (or their holding companies) have raised over $65 billion in capital in the last few months. Their ability to do this speaks to the underlying long-term viability that investors see in these franchises. The additional capital supports these banks' ability to continue providing credit to U.S. borrowers even if other sources of credit remain constrained. While some of the capital was raised at the bank level, most companies kept the capital at the holding company level for greater flexibility.

It is also important to recognize that there are pockets of strength within the banking system. Banks, especially larger institutions, conduct a wide range of activities, and weakness in some lines of business often can be offset by strength elsewhere. In the fourth quarter, while banks were recognizing losses from residential real estate activities, other business lines were generating offsetting income. In addition, banks have diverse funding sources. As a result, despite the difficulties in securitizing nonconforming mortgages, banks continue making mortgage loans, including loans to subprime but still creditworthy borrowers – albeit with underwriting standards that have become more prudent. In contrast, some nonbank mortgage lenders had no fall-back options for funding, and a number of them withdrew from the business.

Another positive factor for bank profitability has been the general widening of risk premiums across a broad range of loans and securities to what are, in our view, levels more appropriate for the risks assumed. Similarly, as interest rates have come down the Treasury yield curve has steepened; in the past, a steeper yield curve has often contributed to higher bank margins. And while credit-quality concerns cannot be easily dismissed, delinquency rates on consumer loans are starting from record-low levels, and surveys show that banks have taken steps to limit risk by appropriately tightening loan standards over the last year for credit cards and other non-mortgage consumer credit.

At this point, it is fair to say that the banking system has substantially addressed some – but by no means all – of the problems discussed above. For example:

- Banks have largely taken back on their balance sheet or otherwise addressed the issues arising from subprime mortgage assets that were sold to ABCP conduits and SIVs. Although SIVs that lack bank liquidity support have declined significantly in importance, traditional ABCP conduits have resumed funding at more normal levels.

- Thanks to proactive liquidity actions by central banks, earlier problems in interbank markets have receded, at least for the time-being.
- Banks have made significant progress in recognizing large and concentrated losses caused by subprime mortgage CDOs and other asset deterioration. Even more important, they have succeeded in raising large amounts of capital to restore strength to their balance sheets to offset these losses.
- The purchase of the country's largest mortgage originator by one of the biggest national bank holding companies helped to calm credit markets.
- And banks have reduced their exposure to the combined volume of leveraged loans and pipeline commitments, even though a significant amount of funded loans remains on their books.

III. Near-Term Challenges

Despite this progress, banks still face significant hurdles on several fronts. This period of market turmoil has not run its full course, and a number of critical financial markets remain fragile. Restoring confidence in financial markets has proven more challenging than in other recent periods of market turmoil, such as the late 1990s, for several reasons. Participation in financial markets has broadened, with large numbers of unregulated or lightly regulated entities engaged in financial intermediation and trading activities. Various structured financial products, many of which evolved only recently, can now transfer credit risk among market participants in ways that are not necessarily transparent. This particular market disruption also has highlighted the global nature of financial markets and the ability of market participants to use technology to alter risk profiles quickly. Interconnection among key markets and market participants has fueled worries about contagion. Taken together, these factors complicate current problems and lengthen the road to full recovery.

Continuing market turmoil presents a variety of issues for banks and for regulators. Although as noted earlier many larger banks have revalued their mortgage-related CDO exposures to recognize losses, it is entirely possible that, as housing markets continue to weaken, there will be additional write-downs on these securities. Similarly, although banks have made progress in reducing their exposure to leveraged loans, they remain exposed to potential losses in this area; this is also a line of business that has come to depend heavily on liquid markets for funding, and liquidity risk management remains a challenge as the cost and tenors of available funding options remain volatile.

Recent problems among monoline bond insurers, who insure municipal bonds and provide credit protection on structured securities such as ABS CDOs, also pose problems for banks. National banks have relatively moderate direct exposure to these companies in the form of direct credit obligations. In addition, national banks' indirect risks from exposure to insured municipal bond holdings in investment portfolios are relatively modest; the underlying bonds tend to be highly rated on their own, which should minimize the effect of monoline downgrades. However, a more significant concern is that banks may be obligated as part of their municipal remarketing activities to repurchase securities from investors. Downgrades of the monoline insurers would make it more likely that policy constrained investors would "put" these securities back to the remarketing banks. If this happens in large volumes, banks would incur price and liquidity risks, and would face increased strain on their capital ratios.

Most recently, problems with auction-rate securities have received considerable attention. This is a market in which some of the larger national banks are involved through their broker-dealers. Investor concerns linked in part to the weakening financial condition of monoline bond insurers has in some cases disrupted the normal functioning of the periodic auctions that are used to set interest rates on these types of securities. In the past, when there was insufficient investor demand in the auctions, dealers have purchased securities to assure a successful auction. However, given current liquidity and balance sheet constraints, and the absence of a contractual requirement for dealers to purchase securities in the auction, many auctions are now failing. The result is that issuers of these securities, such as municipalities and universities, are scrambling to find alternative ways to borrow funds.

The weak financial condition of some monoline insurers, and the disruption created by uncertainty and investor concerns regarding that condition, not only creates various risks for banks, but likely delays a return to normalcy. On the other hand, if recent efforts to recapitalize monoline insurers successfully restore their triple-A ratings, or allow them to retain those ratings, the corresponding risks to banks will be mitigated.

Looking beyond the immediate fallout of financial market disruption, deteriorating credit quality is likely to remain a big issue across the national banking system in the near term. Housing markets continue to slide in much of the country; analysts generally expect at least another year before the housing sector turns around, and banks will continue to feel the impact. Slower economic growth and the sharp fall-off in home building are reducing loan demand and restraining revenue growth for banks. General economic weakness implies more losses to come on home equity loans, credit card loans, and auto loans, as consumers face a softer job market along with near-record debt service burdens.

Commercial real estate (CRE) will be an area of challenge for bankers and bank supervisors, and its impact could be quite broad. During the prolonged period of exceptionally benign credit conditions that I discussed earlier, many community bankers became complacent about the potential for significant stresses in these markets. Lending growth was historically high in commercial real estate, especially in regions of the country that enjoyed an extraordinary boom in the housing markets. CRE concentrations rose around the country, and in some cases risk management failed to keep pace.

Approximately a quarter of the community banks supervised by the OCC now have CRE-related concentrations exceeding one or both of the thresholds contained in the interagency CRE guidance issued in December 2006.[4] The share is even higher in the former housing boom regions. Credit quality is now declining for many of these loans, especially those related to residential construction and development (C&D). For example, at the end of 2007, nonperforming C&D loans at national community banks amounted to 2.7 percent of the total, more than triple the rate of a year earlier. This trend is particularly pronounced in the former housing boom states.

CRE exposures are smaller relative to capital at the largest national banks than at community and mid-size banks, because larger banks have tended to originate CRE

[4] The concentration thresholds articulated in the guidance are commercial real estate loans (excluding owner-occupied real estate) exceeding 300 percent of risk-based capital, or construction and development loans exceeding 100 percent of risk-based capital.

exposures for distribution via commercial mortgage-backed securities (CMBS). As seems to have been the case for other loans originated with the intent to distribute, underwriting standards for CRE loans deteriorated over the past several years. Interest-only structures, fewer covenants, and financing based upon optimistic projections of cash flows rather than actual in-place cash flows are examples of the more aggressive underwriting terms. As risk appetites of investors have changed in the wake of market disruptions, securitization of CRE has become very difficult as well. As a result, several of the largest national banks experienced some losses when warehoused loans and security exposures declined in value. The banks also retain significant exposures to residential builders, many of which have struggled under recent market conditions, and to income-producing CRE loans.

IV. Supervisory Responses

As the supervisor of national banks, the OCC has various ways to influence the national banking system: policy guidance and regulations that set forth standards for sound banking practices; on-site examinations and ongoing off-site monitoring that enable us to assess compliance with those standards and identify emerging risks or trends; and a variety of supervisory and enforcement tools – ranging from reports of examination that highlight matters requiring attention to informal and formal enforcement actions – that are used to obtain corrective action to remedy weaknesses, deficiencies, or violations.

Current market and economic conditions highlight the importance of appropriately identifying, measuring, managing, and controlling risk. Based on what we have observed so far in this period of market turmoil, there is a need to restore several fundamental banking precepts: first, sound underwriting and robust credit administration practices; second, diversified funding sources supplemented with realistic contingency funding plans; third, strong internal controls and risk management systems, including stress-testing, valuations, and disclosures; and fourth, timely recognition of losses coupled with adequate loan loss reserves and strong capital cushions. In each of these four areas – asset quality, liquidity, risk management, and reserves and capital – we remain alert to emerging trends and to findings that may trigger additional supervisory action.

A. Asset Quality

1. Monitoring and reviews

A core component of our supervision is monitoring and assessing the quality of national banks' loan portfolios. Our assessments of individual bank risks are supplemented by a variety of mechanisms to determine potential risks, including on-site loan reviews at individual banks; horizontal reviews of particular portfolios or operational areas across a group of banks; an annual credit underwriting survey; and the agencies' Shared National Credit Program. Through these mechanisms we look for trends that may signal systemic weaknesses or increases in risk that warrant supervisory responses. Responses may take the form of more targeted supervisory examinations or additional policy guidance.

Our annual credit underwriting survey that is currently underway, and the agencies' Shared National Credit reviews that will commence in April, will provide us with an updated picture of the aggregate level of credit risk in the banking system. Findings from these reviews will help identify areas where we may need further targeted examinations or additional supervisory guidance to bankers and examiners.

The OCC's underwriting survey covers the largest 64 national banks, whose combined loan portfolios represent approximately 94 percent of all outstanding loans in the national banking system. The survey provides information on how national banks are responding to recent developments and adjusting their underwriting standards across 18 major retail and commercial loan products. It also provides examiners' assessments on trends in the aggregate credit risks for each of these product categories. In the 2008 survey, we are specifically asking about deviations from sound underwriting, and about any differences in the diligence of underwriting by product or intended hold positions.

The agencies' Shared National Credit Program will provide detailed on-site reviews of large syndicated credits that are shared by two or more banks. This program typically involves reviewing over 7,000 individual credits that total in excess of $2 trillion in credit commitments. During the 2008 Shared National Credit review, the agencies will focus on credits extended to the residential homebuilding industry, other commercial real estate construction loans, loans to mortgage and consumer finance companies, merger and acquisition loans, and loans to monoline insurance and subprime lending companies. A key focus of examiners' evaluations will be whether banks' internal credit review processes are proactively identifying and classifying credits that are showing inherent weaknesses. Banks that have failed to take appropriate charge-offs or provisions for probable losses will be directed to do so and to take concrete action to strengthen their credit administration.

Examiners also will continue to evaluate differences in underwriting between extensions of credit originated to hold for investment, versus originated with the intent to distribute. In the past, we issued guidance to our examiners stressing the importance of sound underwriting and the need to have distributed credit underwritten with control and structures that are reasonably consistent with credit exposure held in the bank. We also previously issued guidance requiring examiners to continue to ensure that appropriate risk management systems are in place to effectively measure, monitor, and control risks with leveraged lending activities in banks; examiners will continue to assess and document compliance with guidance regarding leveraged finance and participations purchased when conducting reviews of leveraged lending.

More generally, during our on-site reviews at individual banks, examiners will be conducting portfolio and transaction-level testing tailored to each bank's risk profile to determine the level of credit risk and the adequacy of the bank's credit risk management processes. A particular focus in the coming months will be to ensure that banks are holding adequate reserves for estimated loan losses, and that problem credits are being identified and dealt with in a timely manner. Actual credit losses on individual credits are to be recorded when the bank becomes aware of the loss, but in no case should the charge-off exceed the time frames stated in the agencies' credit classification policies.[5]

[5] For closed-end retail loans, such as auto loans, charge offs are to be taken when loans are 120 days past due; for open-end retail loans, such as credit card loans, charge offs should occur once the loan is 180 days past due. For open- and closed-end loans secured by residential real estate, a current assessment of value should be made no later than 180 days past due and any outstanding balance in excess of the value of the property, less cost to sell, should be classified as loss and charged off. For commercial credits, nonaccrual loans are maintained on a cash basis due to a deterioration in the financial position of the borrower, where payment in full of interest or principal is not expected, or principal or interest has been in default for 90 days or longer, unless the obligation is both well secured and in the process of collection. Proper loan loss provisions are also expected to be taken and losses recognized if appropriate.

2. Supervisory initiatives and guidance

In recent years the OCC has issued more targeted, detailed guidance that is directly applicable to some of the specific portfolios that are of current heightened concern, including certain residential mortgage, home equity, and credit card loans; commercial real estate loans; and leveraged corporate loans. Examiners are assessing banks' compliance with these guidelines as part of their examinations.

a) Residential mortgages

With respect to residential mortgage loans, the OCC alerted national banks to slippage in underwriting standards after our 2003 annual survey of underwriting practices. In 2004, we took further steps to assess the risks associated with these activities, including a survey of national bank originations of interest-only and payment-option adjustable-rate mortgages (ARMs) and the underwriting and marketing practices associated with such products. As a result of our findings, the OCC instructed our examiners to address the risk of products that carry the potential for significant "payment shock" even though home prices were continuing to escalate. We also issued strong standards on predatory lending, and initiated an interagency process to develop policy guidelines to address the safety and soundness and consumer protection concerns that we were seeing in these products. This latter effort culminated with the September 2006 Interagency Guidance on Nontraditional Mortgage Product Risks, which was followed by the June 2007 Interagency Statement on Subprime Lending. Both statements emphasize that loan terms and underwriting standards for such products must be consistent with prudent lending practices, including a credible analysis of a borrower's repayment capacity based on a loan's fully indexed rate, assuming a fully amortizing repayment schedule. The statements also stress the need for consumers to have sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice. Our examiners will continue to assess national banks' compliance with these guidelines as part our 2008 supervisory activities.

(1) Foreclosure prevention

We also recognize, however, the need for banks to work constructively with borrowers who may be facing difficulties with their current mortgage obligations. As a result, we continue to support various private sector and public sector initiatives and programs that seek to assist these borrowers. In particular, the OCC supports the use of the streamlined modification framework for securitized subprime ARMs as outlined by the American Securitization Forum (ASF) and HOPE NOW alliance in December 2007. We also have instructed our examiners to permit banks to apply a similar streamlined approach more broadly, including for loans that have not been securitized, provided that performance and occupancy criteria are no less stringent than those of the ASF plan. In both instances, we believe it is critical that banks construct loan modifications in such a way as to ensure that a borrower has a reasonable prospect of performing under the new terms. Simply shifting a borrower from one unaffordable mortgage to another serves neither the borrower's nor the bank's interest. Through our ongoing supervision and fair lending processes, we will continue to be alert to, and pursue any evidence of, unfair or deceptive or unlawful discriminatory lending practices.

I share the Committee's concern about the effect that current market conditions may have on individual homeowners who face sharply escalating mortgage payments and the possibility of foreclosure. While foreclosures obviously can have devastating effects on borrowers, it is less obvious but no less true that it can also result in steep losses for lenders. As a result, it is very often a "win-win" for both borrowers and lenders to take alternative courses of action to avoid foreclosure, including through loan modifications.

As a result, the OCC has stressed the importance of national banks prudently working with residential loan borrowers facing difficulties in meeting their contractual payment obligations. The OCC is using all available tools to encourage lenders and borrowers to work together, facilitated by supportive organizations such as counseling agencies, to maintain the smooth functioning of the residential lending industry and to help keep borrowers in their homes except where foreclosure is the only prudent course of action. To this end, we are co-hosting forums in parts of the country hard hit by foreclosures to introduce banks to the range of delinquency intervention services that community-based counseling organizations can provide.

In April and again in September of last year, the OCC and other regulatory agencies disseminated guidance to encourage national banks to work with borrowers in these unfortunate circumstances and to remind them of the regulatory incentives to do so. We recognize that many national banks are working with community partners to develop and implement strategies to help identify financially stressed borrowers, pursue workouts, and avoid foreclosure, and we support and publicize these efforts so that they may be replicated and enhanced as much as possible. For example, in June of last year, the OCC published the report, "Foreclosure Prevention: Improving Contact with Borrowers," which sets forth a variety of strategies lenders can use to reach borrowers for whom loan workouts may be necessary and appropriate. In 2006, we dedicated an issue of the OCC's Community Developments newsletter to focus on successful foreclosure prevention partnerships between banks and non-profit organizations and to summarize how CRA credit is available for these activities. This newsletter, and the April 2007 workout guidance, identifies ways that lenders may receive favorable CRA consideration for foreclosure prevention activities, including programs that transition low- and moderate-income borrowers from higher-cost loans to lower-cost loans provided that the loans are made in a safe and sound manner. Consistent with this guidance, the banking agencies have proposed revisions to the CRA Questions and Answers, which provide additional clarification regarding when foreclosure prevention activities may be eligible for favorable CRA consideration. The agencies expect to issue the final revised CRA Q&As in the upcoming weeks.

I have recently visited neighborhoods that have been hard hit by foreclosures, and have spoken with community organizations seeking to mitigate the economic effects of high foreclosure rates. From these visits, it is becoming increasingly apparent to me that a broad range of communities across our nation, including neighborhoods classified as "middle income" in the 2000 Census, are suffering the adverse consequences of rising mortgage delinquencies and foreclosures. I believe that Congress can, and should, do more to provide the statutory authority to ensure that, in addition to low- and moderate-income communities, certain stressed middle-income communities can benefit from bank investments to help alleviate the disastrous effects of rapidly escalating foreclosures. The Senate is now considering S. 2487 to restore the original scope of national banks' public welfare investment authority, which would give banks an important tool to help foreclosure-plagued urban and suburban middle-income areas. A companion bill, H.R. 1066, has unanimously passed the House. I would hope the Senate would move quickly to pass this legislation so that this important bill can go to conference with the House and ultimately to enactment.

In order to ensure that banks receive appropriate CRA consideration for these investments, I have proposed an amendment to the CRA regulations that would provide an incentive for community development investments that revitalize and stabilize middle-income urban and suburban areas that are "distressed" based on unprecedented levels of foreclosures and related economic factors. With this change, the banking agencies could give favorable CRA consideration for – and thereby encourage – loans, services, and investments in more communities suffering from the consequences of foreclosures.

(2) New mortgage reporting metrics

To improve our ability to monitor the quality of banks' residential mortgage portfolios, including modifications of existing mortgage loans, the banking agencies recently announced the addition of new items to the quarterly Consolidated Report of Condition and Income (Call Report) and Thrift Financial Report filed by banks and savings associations. Specifically, beginning with the March 31 reports, institutions will report the total dollar value of one-to-four family residential mortgage loans owned or serviced by them that are in the process of foreclosure as of the quarter-end date, and also will report restructured loans secured by one-to-four family residential properties. These amounts will be broken into two categories: loans that are in compliance with their modified terms, and loans that under their modified terms are past due 30 days or more or in nonaccrual status.

In addition, we are requiring the largest national bank mortgage servicers to submit comprehensive mortgage data to the OCC on a monthly basis. We expect the data will cover more than 95 percent of the mortgage servicing activity in the national banking system. The OCC is requiring this comprehensive mortgage data in order to ensure that we have a detailed picture of the activities of national bank servicers and the performance of loans serviced by them.

The scope of the mortgage data we are requiring is not limited to subprime mortgages or to mortgages serviced in securitization pools. We believe it is important to obtain key mortgage performance metrics across a broader base, and therefore, our data collection covers all mortgages held on the books of national banks and their subsidiaries, as well as loans serviced for others. The data will use common definitions and data elements for asset quality metrics (delinquency measures, foreclosures, and so on), loss and foreclosure mitigation actions taken, and credit risk indicators (such as credit bureau scores). With this approach, we will have data that is consistent, comparable, and reliable.

We also believe that it is important to build upon, and not conflict with, the mortgage data collection efforts of the HOPE NOW Alliance. Thus, in designing our data collection, the OCC has been coordinating with participants in the HOPE NOW Alliance in order to coordinate data collection efforts and minimize burden. We understand that as a result of their review of the information sought by the OCC, the HOPE NOW Alliance decided to revise and expand its subprime mortgage metrics to be more consistent with the enhanced metrics to be used by the OCC. Similarly, we have revised our OCC mortgage metrics and definitions in some respects so they are compatible with the HOPE NOW data collection. I have been pleased that the banks we are requiring to submit mortgage data recognize the importance of this effort and have committed to prompt fulfillment of the OCC's requirements. Our aim is to have the largest national bank mortgage servicers begin submitting reliable data as soon as March 31.

b) Home equity

National banks' home equity portfolios grew considerably over the last several years, fueled by the low interest rates, rising home prices, and relaxed underwriting standards discussed earlier in this testimony; growth averaged 29 percent per year from 2001 to 2006. National banks have about half of this market, and almost all of the exposure is held on the banks' balance sheets.

In our 2003 targeted reviews of home equity lending, we identified changes in the product structure and underwriting that were increasing the risk inherent in these portfolios. These changes included extended draw periods with interest-only payments, acceptance of higher debt-to-income and loan-to-value ratios, and greater use of stated-income and other reduced documentation products. As result of these findings, we advised bankers to strengthen their credit risk management practices, and the OCC worked with the other FFIEC-member agencies to issue the 2005 guidance on Credit Risk Management for Home Equity Lending. The guidance sets forth sound credit risk management practices for nine key areas including marketing, underwriting, collateral valuation management, individual account and portfolio management, and servicing.

While national banks have taken steps to strengthen their underwriting and risk management practices in response to our guidance, losses have recently accelerated from a low base. Losses reflect the increased risk that accumulated in these portfolios over the last several years through gradual loosening of underwriting standards and increased risk layering – especially with respect to loans purchased from third party brokers or correspondents. These built-up structural weaknesses, together with the spreading weakness in home prices, lead us to expect higher losses in these portfolios in the months to come. Despite the higher losses and the likely need for additional provisions, problems are likely to be manageable for national banks; home equity loans account for less then 5 percent of national bank assets.

c) Credit cards

The OCC also regulates institutions that account for approximately 75 percent of the credit card industry. The 2003 interagency guidance on Credit Card Account Management and Loss Allowance Practices addressed a number of inappropriate account management, risk management, and loss allowance practices identified through our examinations. These practices, which often increased credit risk and masked portfolio quality, included increased negative amortization, liberal credit line management, certain overlimit practices, and a general easing of minimum payment requirements.

Although we faced considerable criticism by some that our guidance and actions could have negative repercussions on bank profitability and consumer spending, we thought it was critical to curtail the continuing liberalization that we were seeing with regard to minimum payments. At the OCC, we directed all national bank credit card issuers to revise their minimum payment policies to ensure that those payments were sufficient to cover, at a minimum, all accrued interest and late fees plus at least one percent of the principal balance outstanding. In addition, we required banks either to include other recurring fees (such as overlimit fees) in the minimum payment, or to waive them after three consecutive months.

Although credit card earnings have been fairly robust and portfolios are currently strong, we have a heightened level of concern in this area, even before the numbers confirm any significant deterioration. This is unsecured credit, and is very susceptible to a mortgage spillover effect. National bank credit card delinquency and loss rates are on the rise, although from exceptionally low levels as noted above. Industry losses are running approximately 5 percent; this is currently below the long-term industry average of 5.5 percent, but losses may migrate to that rate or higher in 2008. These trends require that we continue to devote attention to this type of credit; however, the number of affected national banks is relatively small, and the potential problems, taking into account the possibility of some further decline in economic growth, appear manageable within the broader spectrum of current issues.

d) Commercial real estate and construction

Because of the growing CRE concentrations of community banks described earlier in this testimony, the OCC started conducting horizontal reviews of national banks with higher CRE concentrations about four years ago. These reviews, which brought together teams of highly experienced examiners, allowed the OCC to identify and convey best practices more effectively, and provide consistent advice on any additional measures that we believed should be taken. As a result of these reviews, we provided guidance to national banks on areas that needed improvement, and used our findings to help formulate guidance that the agencies issued in December 2006 on sound risk management practices for concentrations in commercial real estate lending. That guidance is intended to help ensure that institutions pursuing a significant commercial real estate lending strategy remain healthy and profitable while continuing to serve the credit needs of their communities. It reminds bankers of the increased risk that arises from these concentrations, and sets forth our expectations for evaluating this risk.

But results from our more recent horizontal reviews have continued to show a number of risk management deficiencies that cause us concern. For example, despite our previous guidance, a number of banks with CRE concentrations have not extended their stress testing of income-producing properties beyond interest rates to other business variables that affect risk, such as vacancy rates, lease rates, and expense scenarios – not only at the time the loan is made, but also periodically throughout the life of the credit relationship. The potential for rapid deterioration in this business is simply too great <u>not</u> to conduct such testing on an ongoing basis.

Another issue that has surfaced in horizontal reviews involves real estate appraisals. We have seen an increasing number of instances in which appraisals on file have become outdated with respect to current market conditions, making it very difficult to assess the true credit quality of these loans. In these cases, we will require bank management to obtain new appraisals, thoroughly review those appraisals, and take any action necessary should these loans no longer be adequately supported by collateral values.

Our horizontal reviews have definitely revealed a significant increase in the number of problem loans related to residential construction and development in community banks across the country, especially in the "boom-bust" areas that experienced rapid appreciation followed by downward pressures on home prices. In the coming months we will continue focusing our supervisory efforts in these geographic areas and on banks with greater concentrations in this segment of CRE; many of these banks are already seeing an increase in their problem loans and loan loss provisions for this part of their portfolios. We believe that our "supervision by risk" approach works well in these situations, as we can tailor our work to the specific facts and circumstances of individual banks without having to adopt a "one size fits all" solution.

The trend of increasing problem assets is unmistakable, and the potential consequences are magnified in this credit cycle by the fact that so many community banks have CRE concentrations that are so much higher than has ever been the case in the past. While we fully expect to see further increases in problem assets, increases to loss reserves, more problem banks, and some bank failures, this progression is not inevitable just because a bank has a commercial real estate concentration. It remains imperative, as we enter this more stressful period for community banks with concentrations in commercial real estate lending, for bank management to be realistic about identifying problem assets themselves, so that our examiners are not forced into the position of having to do it for them. The idea is to recognize problems early and manage through them, with good and continual communications between examiners and bankers.

Although the larger banks generally have lower concentrations of CRE credits on their books, some have large dollar volumes of CRE exposure. As with community banks, CRE exposures related to residential construction and development present particular concerns. Housing-related CRE outstandings comprise only 1.6 percent of large bank loans, but a number of them have experienced significant deterioration. We recently subjected these portfolios to a horizontal analysis and are targeting them in our supervisory strategies and in the Shared National Credit review. We also continue to ensure that banks maintain adequate reserves against these portfolios.

At larger banks CRE weakness takes on a different character, as noted earlier in this testimony. For the large banks, disruption in CMBS markets and securitization activities has led us to monitor the actions, such as write-downs and whole-loan sales, that banks are taking to reduce warehouse exposures. However, the absence of a functioning securitization market likely will make progress slow. As a result, we may see additional losses at banks that hold the underlying CRE loans and securities.

e) Leveraged lending

As noted earlier, market disruptions last summer delayed completion of long-term financing for some leveraged loans that banks had not expected to hold on their books. We continue to closely monitor the inventory of these loans held at the larger national banks and the potential adverse affects such holdings may have on those banks' asset quality and balance sheet capacity. As warranted, we will direct banks to take appropriate write-downs on these holdings to reflect current market conditions. Last week we issued a Leveraged Lending handbook that consolidates and supplements existing guidance to bankers and examiners on the risks associated with leveraged lending and the risk management systems and controls needed to mitigate those risks.

These systems and controls include sound underwriting standards; appropriate concentration limits; robust problem loan management; and clear policies and procedures on loan acquisition and distribution, including procedures for defining, managing, and accounting for distribution failures and methodologies for determining market values and promptly recognizing losses for loans classified as held-for-sale.

Leveraged lending has been and will remain a supervisory focus. We are in process of conducting leveraged lending target reviews in our top syndication banks, with a focus on syndication pipeline management, stress testing, and limit setting. Similar to the 2007 Shared National Credit review, we will be completing underwriting analysis questionnaires on selected new leveraged loan syndications in our upcoming shared credit examinations. As before, this work will allow us to identify and quantify the volume of weakly underwritten credits.

B. Liquidity and Funding

As part of our supervision of bank safety and soundness, we require national banks to carefully monitor their liquidity and funding levels and to have contingency plans in place that contemplate a potential disruption to their normal funding activities and market access. As we have seen, market liquidity can change rapidly and unpredictably. However, these changes in market liquidity need not unduly threaten the health of the banking system, provided banks take responsible steps to manage their own institutional liquidity. And in general, national banks have been able to maintain adequate funding for loans and other credit activities throughout this period of market turmoil.

Although most national banks continue to have sufficient funding to meet loan demand, unprecedented dislocations within the secondary mortgage, leveraged loan, and asset-backed commercial paper markets have posed challenges for banks active in these markets. Our examiners at these institutions continue to monitor market conditions, deal flow, and funding availability. We are also working with other U.S. and international supervisors to assess the effectiveness of existing liquidity risk management practices and to identify areas where practices must be strengthened. One specific focus is the likely need for banks to enhance the identification and mitigation of contingent funding risks, such as those associated with loan syndication and off-balance sheet structures and commitments.

C. Risk Management Systems and Controls

The events of the past few months have exposed a number of areas where we will be directing banks to improve their risk management systems and controls. A key area of supervisory attention in the coming year will be the need for enhanced stress testing to improve the evaluation of potential so-called "tail events" or extreme market movements, particularly those in which markets that in normal times appear quite independent suddenly move more in tandem. Model validation processes, methodologies used to value complex or illiquid instruments, counterparty credit risk management, and credit risk mitigation tools are other areas where we will be working with other supervisors to determine whether additional standards or guidance are needed.

While these efforts related to modeling and stress testing primarily focus on larger institutions, we expect smaller banks that have significant portfolio concentrations to have adequate systems and processes in place to manage these concentrations, whether they are tied to commercial real estate or to any other type of lending. Banks' processes should include assessing how changing market conditions may affect their borrowers' ability to repay their loans, and the impact on the bank's asset quality, earnings, and capital.

The goal of OCC supervision is to identify and correct potential problems at an early stage, before they adversely affect the safety and soundness of the banking system or the viability of any individual bank. We use our various tools – supervisory policy guidance, on-site examinations and communications between bankers and examiners, and where needed, informal and formal enforcement actions – to achieve such changes. Notwithstanding these efforts, we fully expect given current market conditions that we will see an increase in problem banks that will require more in-depth supervisory attention. As a bank reaches this stage, our efforts focus on developing a specific plan that takes into consideration the ability and willingness of management and the board to correct deficiencies in a timely manner and return the bank to a safe and sound condition. In most instances our efforts, coupled with the commitment of bank management, result in a successful rehabilitation of the bank. There will be cases, however, where the situation is of such significance that we will require the sale, merger, or liquidation of the bank. In rare cases where that is not possible, we may appoint the FDIC as receiver, such as occurred in one instance this January. We work closely with the FDIC in these cases to effect early and least-cost-resolution, consistent with the provisions of the Federal Deposit Insurance Corporation Improvement Act.

D. Reserving and Capital Standards

Prompt recognition of losses and the maintenance of strong loan loss reserves and capital buffers are essential in preparing for, and responding to, periods of economic stress. Failure to recognize losses erodes investor confidence and impedes the ultimate resolution of problem credits. To provide for estimated credit losses, banks must employ a robust methodology for determining and maintaining an adequate allowance for loan and lease losses (ALLL). As we have seen in the fourth quarter, many banks are increasing their loan loss reserves – a development that we believe is both warranted and prudent in the current environment. We will continue to direct banks to maintain adequate reserves to cover their estimated credit losses.

In December 2006, the banking agencies issued guidance and supplemental frequently asked questions that set forth supervisory expectations and generally accepted accounting principles for the ALLL. At the OCC we followed up with a 2007 ALLL training initiative that provided training sessions for over 1,200 examiners on key ALLL concepts and practical case studies that address many of the current issues examiners are facing in their credit examinations.

U.S. banks entered the recent market upheaval with strong levels of capital, as noted earlier. This period has been a useful reminder, if we needed one, that capital standards are a crucial line of defense against problems that might threaten the stability of the banking system. To strengthen that crucial element of our prudential regulations, the U.S. banking agencies recently adopted a final rule that implements the advanced approaches for risk-based capital established under the Basel II Framework. Specifically, for the largest U.S. banking organizations the rule establishes regulatory and supervisory expectations for credit risk, through the Internal Ratings-Based Approach (IRB), and for operational risk through the Advanced Measurement Approaches (AMA), and articulates enhanced standards for the supervisory review of capital adequacy and for public disclosures related to risk and capital adequacy.

The IRB and AMA frameworks represent a more risk-sensitive and comprehensive regulatory capital regime than our existing risk-based capital rules, and establish capital requirements and risk management expectations that are better aligned with the risks assumed by these institutions. The IRB framework provides a more granular assessment of the capital needed to support both on- and off-balance sheet credit risk exposures of banks; this increased granularity should help address some of the shortcomings in the current risk-based framework that often provided incentives for institutions to take on more risky exposures. Under the AMA framework, banking organizations will be required to have systems in place to measure and hold capital explicitly for potential operational risk losses.

Our implementation of the advanced approaches of Basel II incorporate a number of transitional arrangements and prudential safeguards designed to ensure that the new framework is working as anticipated. These safeguards include a parallel run period that will last at least four quarters but could be longer for individual institutions, which will provide the basis for the OCC's initial Basel II qualification determination. During this period, banks will be required to demonstrate adherence to stringent qualification requirements on all aspects of their credit and operational risk measurement and management process. Following initial qualification, a minimum three-year transition period would apply, permitting supervisors to observe and scrutinize Basel II systems while strictly limiting, through a system of simple and conservative capital floors, any potential reductions in capital requirements. In addition, banks operating under the advanced approaches will continue to be subject to the agencies' leverage capital and Prompt Corrective Action requirements.

We believe that the advanced approaches final rule is an important step forward in improving our risk-based capital requirements. But as I have noted throughout the development of Basel II, if results from the parallel run or transition periods are unacceptable, I am committed to addressing the shortcomings. In fact, the structure of the Basel II rule was designed to allow us to make adjustments to regulatory requirements on the basis of bank implementation activities and to make informed changes while prudential transition safeguards are still in effect. In this regard, the U.S. agencies, independently and in conjunction with the Basel Committee on Banking Supervision, are reviewing the treatment of certain CDOs and securitizations in the Basel II Framework to determine if further enhancements are warranted.

V. Conclusion

In conclusion, while the condition of the national banking system remains fundamentally solid, the challenges of the last few months are undeniable, as are the likely challenges that remain. As I have described in my testimony today, the OCC is carefully monitoring the credit, market, and liquidity risk management activities at national banks. We also are working with large banks to identify and evaluate critical risk management pressure points, and are assessing more broadly the potential for the current economic downturn to have negative consequences in the wider population of national banks. In addition, the OCC is leading or participating in work being conducted by broader groups of policymakers such as the President's Working Group domestically, and the Basel Committee on Banking Supervision, the Joint Forum, and the Financial Stability Forum Working Group internationally.

Without a doubt there are more challenges to come, many of which I have touched on in this testimony. However, virtually all national banks remain well capitalized. Many of the specific concerns I have discussed today may reduce income for banks, but they are considerably less likely to lead to any widespread threats to their viability. Indeed, the resilience of the banking system has allowed banks to at least partially step into the breach and continue to provide needed credit as nonbank sources have been forced to pull back.

But as I hope I have made clear, this is a storm that was years in the making: the problems we are now facing are the result of a complex set of forces and market developments that have been building for some time. It is simply not realistic to expect that every problem can be fixed overnight, or that all damage can be avoided. We have made some encouraging progress, but it will take diligence, patience, and hard work to ensure that we continue to have the kind of strong, healthy banking system that Americans expect and deserve.

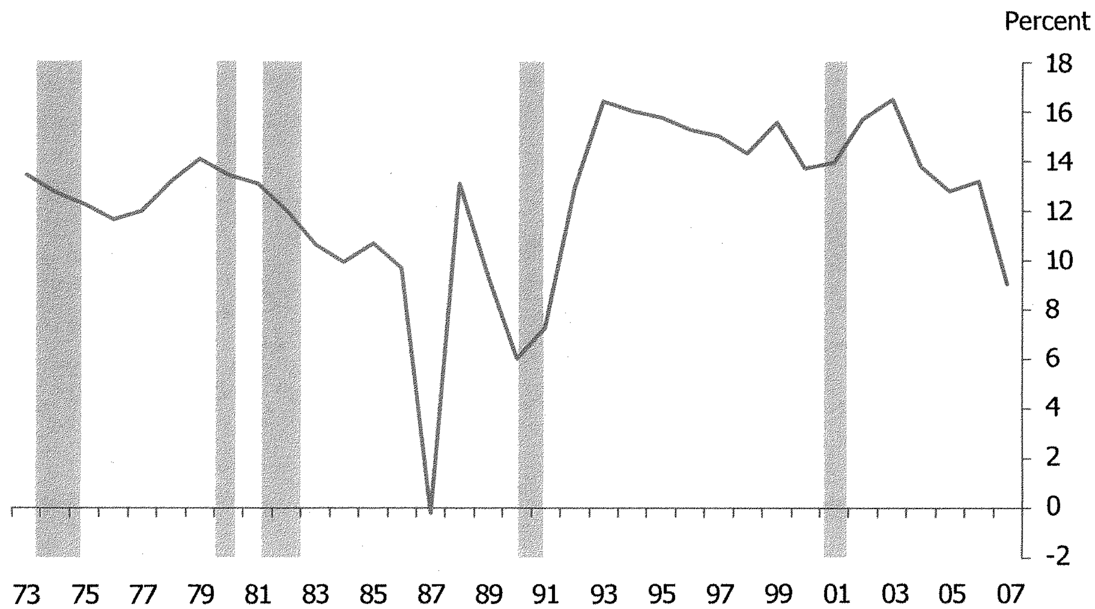
Comptroller of the Currency
Administrator of National Banks

Condition of the National Banking System

March 4, 2008

National bank profitability

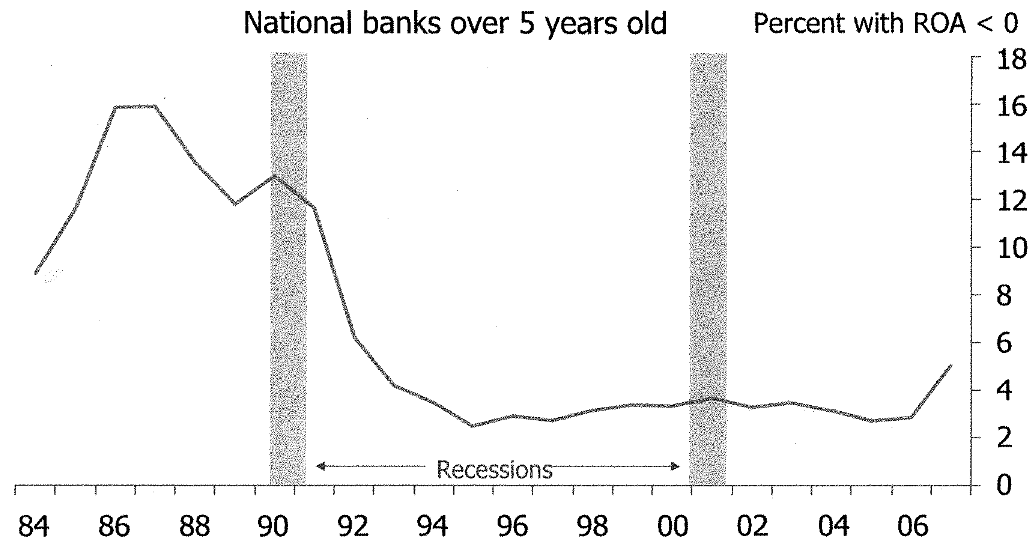
National bank ROE



Source: Integrated Banking Information System (OCC)

Shaded areas represent periods of recession.

Share of unprofitable national banks is highest since the early 1990s

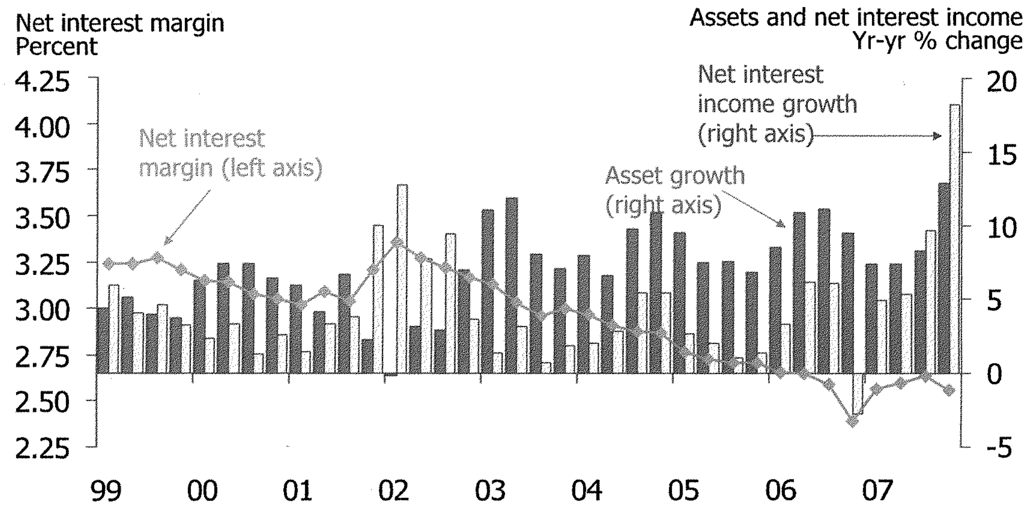


Source: Integrated Banking Information System (OCC)

NOTE: the average bank is not profitable until its 3rd or 4th full year of operation.

Large bank interest income benefiting both from increased assets and modestly higher margin

National banks with assets over $1 billion

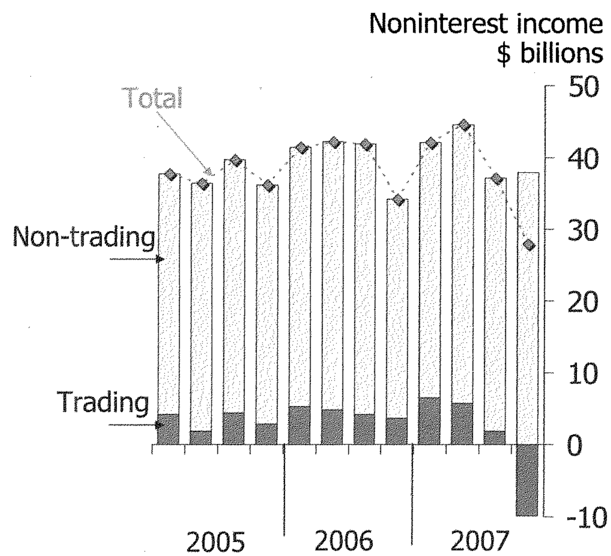


Source: Integrated Banking Information System (OCC)

Data are merger adjusted and held constant for banks operating as of December 31, 2007.

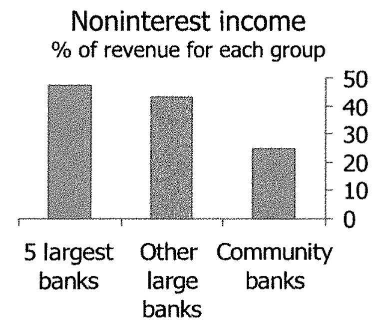
Trading losses at a few large banks cut heavily into noninterest income

National banks



5 largest banks account for:

- 89% of system trading income
- 73% of system non-trading income
- 74% of system noninterest income

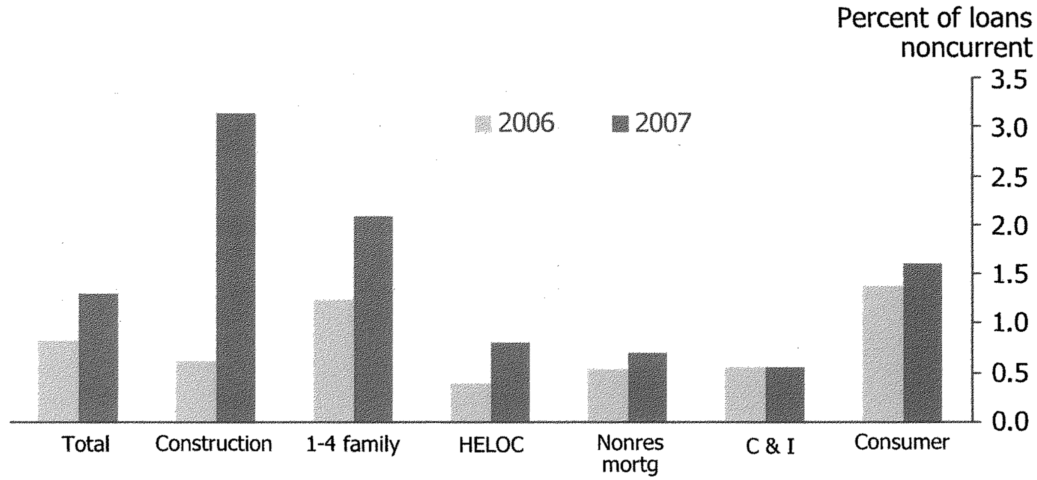


Source: Integrated Banking Information System (OCC)

Data are merger adjusted and held constant for banks operating as of December 31, 2007. Large banks are those identified as supervised by the OCC Large bank program; community banks are under $1 billion in assets.

Noncurrent construction and residential mortgage loans have risen sharply

National banks



	Total	Construction	1-4 family	HELOC	Nonres mortg	C & I	Consumer
Peak rate:	4.4% '91	18.0% '92	2.1% now	0.8% now	7.2% '91	5.0% '91	1.8% '03
Current share of loans:		5%	26%	9%	9%	22%	16%

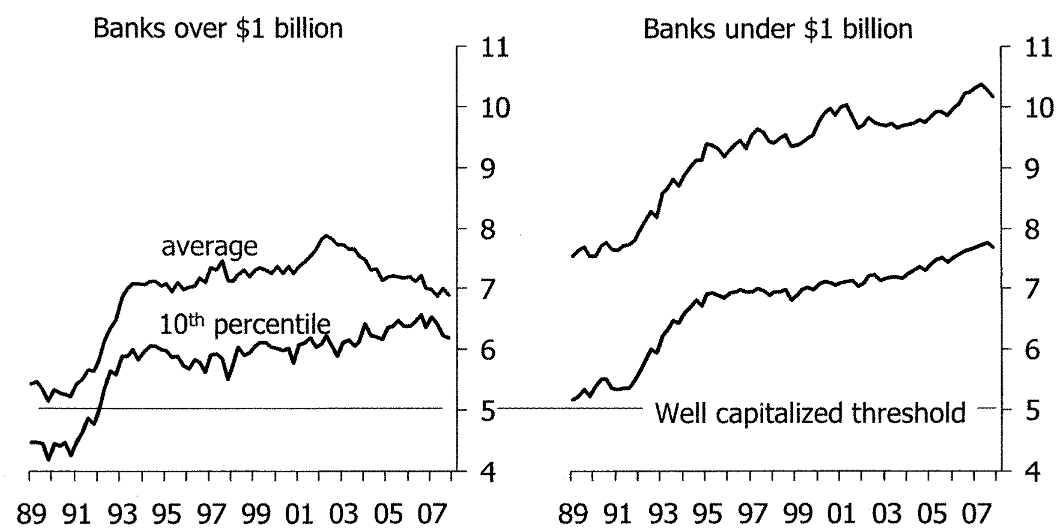
Source: Integrated Banking Information System (OCC)

Noncurrent loans as a percent of loans in respective category.

Capital ratios remain well above their late 1980s levels

National banks

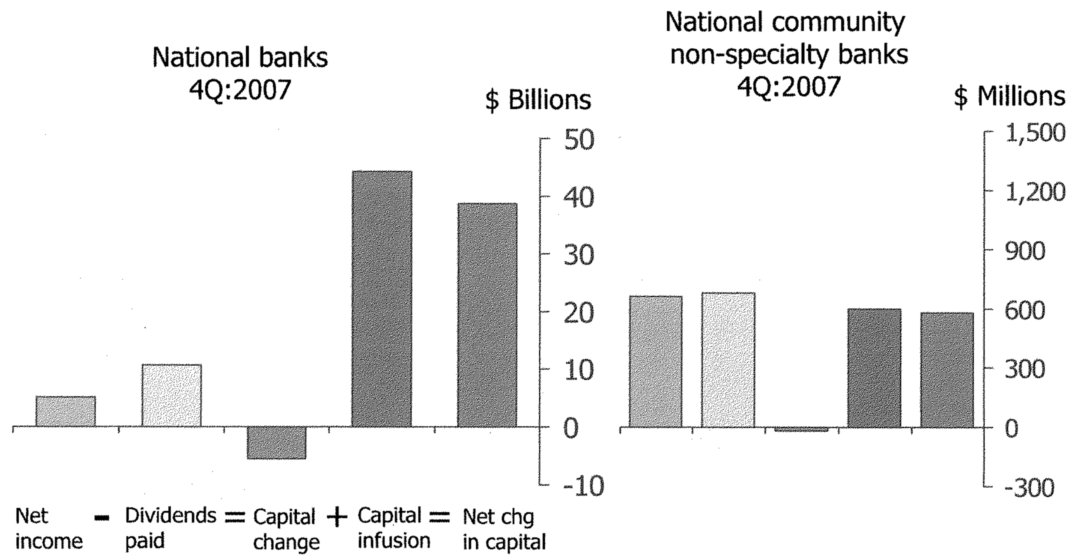
T1 leverage ratio



Source: Integrated Banking Information System (OCC)

T1 leverage ratio is Tier 1 capital as a share of average assets, less disallowed intangible assets.

Dividend payouts exceeded 4Q net income, but capital infusions more than offset this deficit

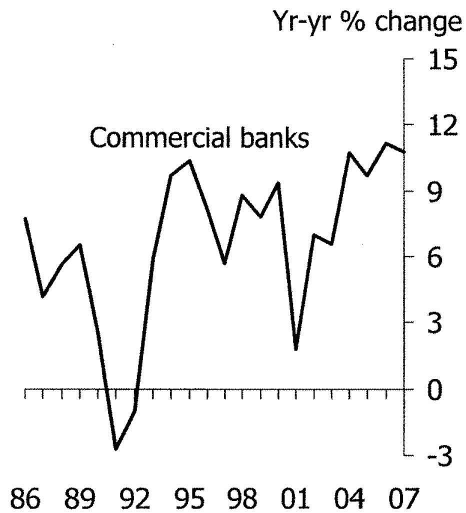


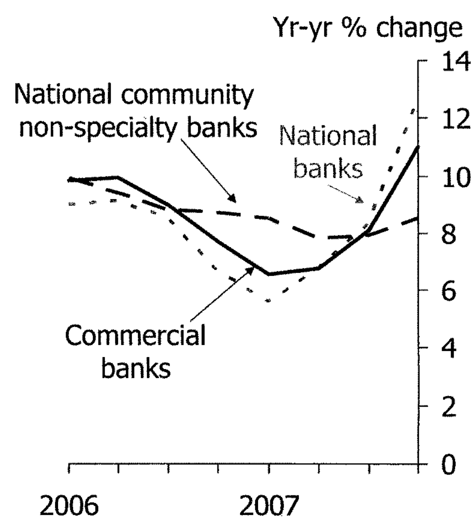
Source: Integrated Banking Information System (OCC)

National community non-specialty banks have assets under $1 billion and exclude credit card and trust banks. "Capital" defined here as total equity capital. 4Q:07 capital change equaled 5% of total equity as of 9/30/07 for all national banks and 2% for community banks.

Small and large national banks continued to expand loan book in the fourth quarter

Total loans





Source: Integrated Banking Information System (OCC)

Data are merger adjusted and held constant for banks operating as of December 31, 2007. National community non-specialty banks have assets under $1 billion and exclude credit card and trust banks.

Embargoed until
March 4, 2008, at 10:00 am

Statement of

John M. Reich
Director, Office of Thrift Supervision

concerning

The Condition of the Thrift Industry

before the

Committee on Banking, Housing and Urban Affairs
United States Senate

March 4, 2008

Office of Thrift Supervision
Department of the Treasury

1700 G Street, N.W.
Washington, DC 20552
202-906-6288

STATEMENT OF JOHN M. REICH
DIRECTOR, OFFICE OF THRIFT SUPERVISION
ON THE CONDITION OF THE THRIFT INDUSTRY
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

March 4, 2008

I. Introduction

Good morning, Chairman Dodd, Senator Shelby, and members of the Committee. Thank you for the opportunity to testify on the financial condition and performance of the thrift industry.

Approximately four years ago, the OTS testified before this Committee on a thrift industry that was strong and growing in asset size. While that trend continues, much has changed in the underlying housing economy that is having a significant impact on thrift lenders. Key measures of financial health – including earnings and profitability, loan loss provisions and net charge offs, and loan performance – have been affected by the downturn in the housing economy over the past year. While industry capital remains strong and asset quality is relatively stable, we are maintaining a watchful eye on credit and interest rate risk, as well as loan performance and industry exposure to the fallout from problems in the subprime lending market. We are also closely monitoring thrift industry exposure to upcoming resets on prime pay-option ARMs that are expected to occur in the next several years.

While a generally favorable interest rate environment continues, the thrift industry's high levels of earnings and profitability from several years of mortgage originations and sales has abated. Although thrift earnings have been challenged in recent quarters, industry capitalization has remained strong due, in part, to good stewardship by thrift managers that have taken proactive steps to address the current challenging business environment.

In my testimony today, I first discuss the state of the OTS-regulated thrift industry, including industry data from our recent year-end earnings release, current supervisory concerns, and market stresses and challenges facing thrift lenders. I also highlight an issue with thrift industry portfolio limits that poses some risks to the ability of the industry to diversify its lending activities. In the next part of my statement, I provide an overview of the OTS's oversight and supervision of the industry, including a discussion of several issues that you have specifically asked us to address, such as troubled debt restructurings, enforcement issues, potential contagion from the subprime market into other lending activities, and real estate appraisals. Next, I address foreclosure prevention and loan mitigation efforts, including the recent OTS foreclosure prevention proposal. I conclude my statement with a discussion of the various ideas for implementing stronger consumer protections in the mortgage markets, including your legislation, Mr. Chairman, S. 2452, the Homeownership Preservation and Protection Act of 2007.

II. State of the OTS-Regulated Thrift Industry

A. Thrift Industry Data/Numbers

1. Overview

The OTS-regulated thrift industry comprises a diverse group of institutions that range from small one-office depositories to large and complex institutions that operate on a nationwide basis. As of December 31, 2007, there were 826 thrift institutions with combined assets of $1.51 trillion. Of these institutions, 39 percent are held in the mutual form of ownership, the historical form of thrift ownership, and 61 percent are stock held depositories. Virtually all stock held institutions operate within some form of a holding company structure.

The majority of OTS-regulated thrifts are full-service, community-based, financial institutions offering a wide range of products to consumers and small- to medium-size businesses. Many thrift institutions use the charter to specialize in retail mortgage and consumer lending activities, but some institutions have a more narrowly focused business strategy. These other operating strategies typically involve a market niche or more narrowly focused business model such as a trust-only charter, a credit card lending focus, or mortgage banking operations.

While there tends to be some diversification with the use of the thrift charter, savings and loan holding companies (SLHCs) are even more diverse. SLHCs are involved in a wide range of businesses and activities, and range in size from small shell holding companies to large international conglomerates. While the predominant characteristic of most SLHC activities involves financial services, there are a number of SLHCs that conduct operations in numerous non-financial activities, including manufacturing, industrial and retail operations. Among the larger and more complex companies owning thrifts are investment banking firms, insurance companies, and diversified financial services firms with international scope.

As of December 31, 2007, the OTS supervised 475 SLHC structures – including 109 mutual holding company structures – with aggregate consolidated assets of approximately $8.5 trillion.

2. Industry Performance

The profitability of mortgage market participants was especially hard-hit in 2007, and this had a significant impact on overall thrift profitability for the year. The OTS-regulated thrift industry posted profits of $2.9 billion for 2007, down from $15.8 billion in 2006. The industry's return on average assets was 0.19 percent for 2007, compared with 1.06 percent for 2006.

Of particular note, the industry recorded a loss of $5.2 billion in the fourth quarter of 2007, a record in terms of dollars, which equated to a -1.38 percent return on average assets for the quarter. While goodwill write-downs of approximately $4 billion by a handful of institutions and a $2.2 billion restructuring charge by one institution were significant components of the aggregate industry loss for the quarter, record levels of loan loss provisioning also played prominently in fourth quarter industry performance.

While nationwide home sales slowed throughout 2007, thrift industry mortgage originations (including 1-4 family and multifamily lending) rose for the year. Total industry mortgage originations were $716.1 billion in 2007, up 12 percent from $642.2 billion in 2006. While total industry originations of $166.6 billion in the fourth quarter were down from $185.7 billion in the third quarter of 2007, the fourth quarter of 2007 was still significantly higher than the $134.3 billion of industry originations in the fourth quarter of 2006.

Despite the relative size of the industry to the broader mortgage market, thrifts continue to account for a sizable portion of the U.S. residential mortgage market, originating 31 percent of total 1-4 family loans in the fourth quarter of 2007. An estimated 9 percent of thrift mortgage originations were ARMs in the fourth quarter of 2007, down from 13 percent in the third quarter of 2007 and from 12 percent of all thrift originations in the year-ago fourth quarter of 2006.

Thrifts currently hold approximately two-thirds of their assets in mortgages and mortgage related instruments. As of December 31, 2007, one-to-four family mortgage loans constituted 48.9 percent of industry assets (including 7.5 percent of assets in home equity lines of credit), 4.1 percent of industry assets were in multifamily loans, and 13.7 percent of industry assets were in other mortgage related instruments. Of total outstanding one-to-four family mortgages and mortgage related instruments held by the industry, approximately 61.2 percent were adjustable rate mortgages (ARMs).

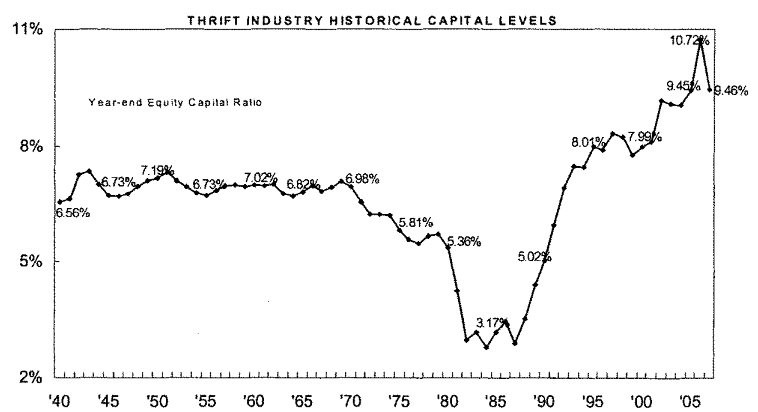
With the impact of a weak housing market on thrift balance sheets, institutions are taking appropriate steps to protect their operations. In particular, thrifts continue to add to their loan loss provisions, which increased to 0.75 percent of average assets for the year from 0.25 percent in 2006. As explained more fully below, the additions to loan loss provisions reflect the increase in non-current loans as a result of the deteriorating performance of loans originated in the past several years.

3. Capital, Provisioning and Loan Loss Reserves

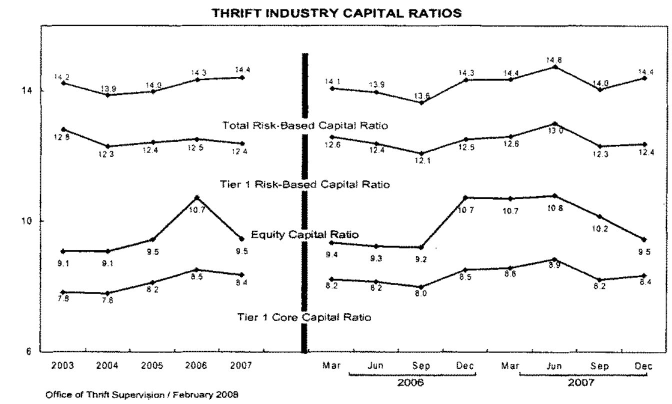
Reflecting the current weakness in the U.S. housing market, thrift managers significantly bolstered loan loss reserves in 2007. The industry's loan loss provision expense for all of 2007 was $11.3 billion (0.75 percent of average assets). It is notable that this amount is close to the combined loan loss provision expense of $11.6 billion for the prior four year period from 2003 through 2006.

As previously noted, in addition to bolstering loan loss provisions, some thrift managers restructured their operations in 2007 to reflect the weak housing market. These restructuring charges – primarily write-downs of goodwill and losses incurred from exiting lines of business – were especially significant in the fourth quarter.

While the current housing market weakness has required charge-offs that have created earnings difficulties, it is important to stress that thrift capital levels remain strong. The industry's equity-to-assets ratio – a measure of capital according to generally accepted accounting principles (GAAP) – was 9.46 percent at year-end 2007. As shown in the chart below, thrift equity-to-assets ratio remains at historically strong level, though down from record high levels from one year ago. The combination of strong capital and bolstered loan loss reserves should help the industry withstand further weakening in the housing market.



Thrift regulatory capital measures also remain strong as shown in the following chart. As of the end of 2007, 98.5 percent of all thrifts – holding 99.8 percent of industry assets – exceeded the "well-capitalized" regulatory standards. Regulatory capital measures exclude goodwill, so these measures were unaffected by the large goodwill write-downs taken in the fourth quarter.



B. Current Supervisory Concerns

1. Overview

There are numerous supervisory concerns within the thrift industry as well as various economic factors affecting the industry that the OTS is closely monitoring. Foremost among these is the rise in loan delinquencies, especially for single-family mortgages and construction loans, attributable to the continued U.S. housing market weakness.

Non-current single family mortgage loans (i.e., loans 90 or more days past due plus loans in non-accrual status) increased to 2.35 percent of all thrift single family mortgages in the fourth quarter of 2007 from 1.61 percent in the third quarter of 2007 and 0.89 percent of thrift single family mortgages one year ago.

We are also closely monitoring the extent to which market unease may continue to inhibit the sale of loans into the secondary market, as well as affect thrifts with business lines of mortgage banking or jumbo loan products. Further, with the shut down in the secondary markets in the third quarter of 2007, many of these institutions had to adjust their entire business model. This may further pressure the profitability of thrifts that are heavily engaged in the origination of residential mortgage loans for sale. While many thrifts adjusted by selling conforming loan products to Fannie Mae and Freddie Mac, exclusive reliance on this model tends to be less profitable and, thus, fails to alleviate earnings pressures.

Thrifts engaged in residential construction lending are also experiencing difficulties from market pressures. Thrift non-current construction loans rose significantly the last quarter of 2007 – to 4.60 percent of all construction loans held by thrifts – which is up from 2.72 percent in the third quarter of 2007 and 0.91 percent of all thrift construction loans one year ago. The over-building that has occurred in many markets has caused increases in delinquencies, extended periods of time for sales and further pressure on earnings.

Even many smaller institutions that, until recently, were operating relatively comfortably are experiencing impact from market stresses. These pressures relate specifically to their interest rate margins. Current market conditions have imposed so much pressure on deposit rates that interest rate spreads have been reduced to very narrow margins. Coupled with a decline in loan volume, these narrow margins are making it increasingly difficult to maintain profitability.

Credit deterioration is also a significant concern. As credit risks increase, loan loss provisions will continue to grow and reduce earnings with a potential future impact on capital. For example, thrift lenders holding so-called "option ARMs" have experienced increased delinquencies even before payment resets, a trend most pronounced in markets where property values have already declined significantly.

At the same time, it is important to be mindful of making sure that lenders do not unduly restrict credit standards and impair the availability of credit. This would only exacerbate an already difficult housing and mortgage market. Rather, a carefully balanced and even-handed supervisory approach will be the most effective in minimizing current and future credit risks.

As described more fully below, the lack of market liquidity, especially in markets for mortgage loans and mortgage-backed securities, is also affecting the ability to obtain an accurate assessment of market value for such assets. This, in turn, makes assessments of the adequacy of loan loss provisions more difficult.

Yet another issue, particularly for a number of medium-sized and larger institutions, is a lack of meaningful diversification. For some of institutions, diversification can be a critical component of their overall organization. As discussed later in this statement, we believe that this is an issue upon which Congress could provide some relief, if even to provide the OTS with case-by-case authority to provide institutions greater flexibility in their consumer and small business lending activities.

Finally, we are closely watching trends in unemployment, home prices, and home absorption rates. Further weakening in these broad measures may cause delinquencies to rise and necessitate higher provisions. And while interest rates are currently stable and near record lows, rising interest rates in the near-term would likely contribute to further declines in home prices and absorption rates.

For now, strong capital and higher loan loss allowances will help the thrift industry meet the challenges of possible further weakness in the housing markets. As highlighted earlier, equity capital and regulatory capital ratios remain high. In addition, the thrift industry loss coverage ratio (loss allowances plus capital to total loans) stands at 14.1 percent, which is down significantly from 15.1 for the prior quarter, but still at a relatively comfortable level. We will continue to monitor this ratio closely in the coming quarters.

2. Recent Examination Findings

a. Capital

During recent reviews, a number of thrift institutions have experienced declines in their capital positions that are caused mainly by operating losses. As noted above, current capital levels generally remain adequate for the risks inherent in most institutions' activities. In some instances, recommendations have been made to establish and implement a capital plan which details actions to ensure maintenance of capital ratios commensurate to the risk profile of an institution. Such plans typically detail alternatives for increasing capital levels.

We have also denied a few dividend payment requests recently to upstream dividends from a thrift institution to its parent SLHC. And there have also been a few instances in which OTS Supervision has required additional capital to be infused into an institution in order to support expanded growth plans or business strategies. To date, we have not experienced reluctance on the part of ownership to infuse additional capital in the few cases where this has been necessary.

b. Asset Quality

As previously referenced, we have seen an increase in overall credit risk since previous examinations. There are similar increases in adverse classifications and delinquent loans relative to capital plus loan loss reserves. And growth in higher risk type loan concentrations has continued.

There have been numerous recommendations recently to establish concentration and loan portfolio limits relative to capital to ensure credit risk is prudently managed. Recommendations have also been made to improve construction loan monitoring and administration procedures to ensure current construction loans remain adequately secured and institution lien positions are maintained.

Pursuant to the increase in problem credits over the last several quarters, we have advised institutions to expand their policies and procedures on impairment testing of commercial loans. We have also made recommendations to increase allocations to institution loan loss reserves for commercial loans – which are typically very collateral dependent – where an impairment test reveals a collateral shortfall.

Other recent asset quality recommendations include reducing the level of problem assets; improving systems for monitoring and classifying assets by strengthening loan review and loan monitoring procedures; identifying and monitoring loans in excess of supervisory loan-to-value (LTV) guidelines and loans-to-one-borrower (LTOB) limitations; strengthening the appraisal review function; bolstering procedures to limit concentrations in commercial real estate; establishing procedures for implementing the Interagency Guidance on Nontraditional Mortgage Products Risks; and improving policies and methodology on the Allowance for Loan and Lease Losses (ALLL).

c. Management

A key area of supervisory scrutiny during times of stress is institution management. Recent exam recommendations have focused on a wide range of management issues. These include reminding directors of the importance of participating in monthly meetings; management oversight and maintenance of capital adequacy; reducing classified assets and maintaining asset quality; strengthening the internal audit function; maintaining a focus on compliance issues and operating within approved business plans and the institution's overall risk profile; promptly filling management and board of director vacancies; and exercising independence from holding company and other affiliates.

d. Liquidity

Given disruptions in the secondary market in recent quarters, liquidity is an area of heightened examiner scrutiny. An increase in wholesale and nontraditional funding sources within the industry has also raised supervisory concerns. This has prompted recommendations to revise some institution liquidity policies to adopt additional limitations on funding sources, as well as ensuring that existing policy limitations are appropriately monitored and enforced. In addition, institutions have been advised to evaluate and monitor deposit concentrations on an ongoing basis, as well as to revise policies and procedures regarding funds management. Finally, a particularly critical issue for some institutions has been reliance on the capital markets for funding (i.e., mortgage banking entities). Where appropriate, we have advised institutions to establish a contingency funding plan to address this problem.

e. Earnings

Earnings, of course, have been a significant challenge for many institutions recently. Net losses in recent quarters have become more severe, particularly as large credit losses were incurred. Recommendations to address this issue typically involve providing the OTS with a plan to improve operating results, including modifying or updating an existing business plan and stabilizing an institution's earnings profile to become less reliant on unpredictable income streams. We have also required various financial monitoring reports, including budget variance, consolidating financial statements, functional profit center reports, and risk management reports to assess potential earnings weaknesses.

f. Interest Rate Sensitivity

Interest rate sensitivity is also an important issue for thrifts given their focus on mortgage lending operations and activities. As discussed later in this statement, the OTS has a highly developed and relatively sophisticated interest rate risk (IRR) net portfolio value (NPV) model that is able to predict with a high degree of accuracy an institution's overall IRR exposure in comparison to its peer lending institutions. OTS examiners use the NPV model to track each institution's overall IRR and will make recommendations, as appropriate and based on the NPV model, to an institution to develop plans to reduce the level of its interest rate risk exposure.

g. Compliance

As noted previously, compliance issues may sometimes get less attention by an institution during times when it is focused on lagging performance or issues related to declining asset quality. This response, however, can often make a difficult situation even worse. Thus, we instruct OTS examiners to be vigilant in evaluating the strength and effectiveness of thrift institution's compliance risk management programs. The focus of our examiners on compliance issues includes ensuring an adequate structure and staffing of the compliance function; adequate reporting to and monitoring by senior management and an institution's board of directors; and special attention to consumer protection laws such as Fair Lending statutes, and Truth in Lending (Regulation Z) requirements.

Other compliance areas that OTS examiners will continue to focus upon during this time of economic stress include flood insurance and compliance with the Flood Disaster Protection Act; and Bank Secrecy Act (BSA) and Anti-Money Laundering (AML) procedures. OTS examiners typically review an institution's policies and procedures for handling and timely filing of Suspicious Activity Reports (SARs). We also are carefully reviewing consumer disclosures for risks associated with non-traditional mortgage (NTM) products and compliance with NTM underwriting guidance.

3. Troubled Assets/Institutions

Notwithstanding the current challenges in real estate lending, the number of problem thrifts – institutions with the lowest composite examination ratings of 4 or 5 – remain at relatively low levels. As of February 29, 2008, 13 thrifts, representing 1.6 percent of the industry, were rated a 4 or 5. Since the end of 2004, only one thrift institution has failed. While we cannot project with any certainty future thrift failures, we are working closely with all institutions currently rated a 4 or 5 to attempt to avoid further deterioration of these institutions and/or identify options to avoid failure.

As noted elsewhere in this statement, overall industry asset quality remains generally sound despite the rise in problem asset levels since the record lows experienced between 2004 and mid-2006 during the extended housing boom. An area of increased OTS oversight is the industry's troubled asset levels (loans over 89 days past due or in nonaccrual status plus repossessed assets), which was 1.65 percent of total assets at December 31, 2007. This is more than twice the ratio of 0.70 percent at the end of 2006. The recent rise in troubled assets was due to the U.S. housing market weakness.

Another measure of problem assets, the ratio of net loan charge-offs-to-average assets, remains relatively low; though, like troubled assets, it is up from the very low levels during the housing boom. Net loan charge-offs (loans or portions of loans written-off as uncollectible and offset by any recovery of loans previously charged-off) measured 0.24 percent of average assets in 2006 and increased to 0.41 percent at the end of 2007.

C. Market Stresses and Challenges Facing Thrift Lenders

1. Housing and the Mortgage Markets

a. The Current Housing Economy

It is expected that the current condition of the housing market will continue to have a significant impact on the thrift industry going forward. The extent and duration of the impact, however, is difficult to predict. Among the factors impacting thrifts are housing starts (for single and multi-family dwellings), which are down 27.9 percent from a year ago and, more significantly, are 60.2 percent lower in the last three months. New construction of single-family homes fell by 33.8 percent from a year ago, as home builders struggle to trim overloaded inventories. January marks the twelfth consecutive monthly drop in single family production, suggesting the contraction in the housing market is much deeper than initially projected.

According to the U.S. Department of Commerce, purchases of new homes – often a leading indicator of housing conditions – fell to a 12-year low of 588,000 units in January. For 2007, sales were down 26 percent, the worst sales decline since recordkeeping began in 1963. Prices of new homes remained under pressure with the median sales price falling 15 percent from a year ago to $216,000, the largest decline in 17 years. The number of new homes for sale fell to 482,000 in January, but given the current sales pace, it would take 9.9 months to sell these homes – the longest period in over 20 years.

In January 2008, sales of existing homes, which account for 85 percent of all home sales in the U.S., fell 23 percent from a year ago to 4.89 million units, the largest yearly slump in more than a decade. According to the National Association of Realtors (NAR), the inventory of existing homes available for sale rose more than 5.5 percent last month, resulting in 10.3 months of inventory (assuming the January 2008 sales pace). These inventory levels are very near the peak reached in October 2007. The median price of an existing single-family home fell 5.1 percent on a year-over-year basis in January. According to the NAR, the record low of 7.2 percent was recorded in December 1968. The current pace of home sales and large number of available new and existing dwellings suggest continued lower prices in the near term.

The plunge in home sales in 2007 resulted in the lowest yearly production of single-family loans since 2001. Approximately $2.43 trillion in mortgage loans were originated last year, which is 18.5 percent less than in 2006.[1] As expected, originations of subprime and Alt-A loans were also significantly lower, especially in the second half of 2007. Subprime loan issuance was down 61 percent from the third to fourth quarter of 2007 for a total of $11.94 billion, 55 percent less than 2006.

Mortgage loan performance also deteriorated in December 2007, as reported by LoanPerformance.[2] The national delinquency rate for prime loans climbed to 3.44 percent in December 2007, almost a full percentage point higher than a year ago. On a monthly basis, greater borrower stress was exhibited by subprime and Alt-A loans, which experienced a 1.29 percent and 0.96 percent increase, respectively, in late payments from November to December 2007. Foreclosures displayed similar characteristics with larger monthly and yearly increases in ARMs and non-prime mortgages.

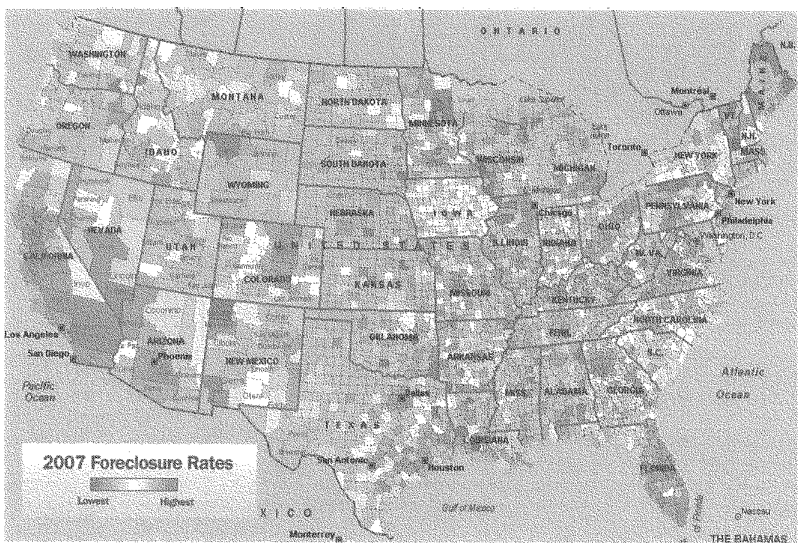
b. Current State of the Mortgage Markets

Another indicator of home prices, the S&P/Case Shiller® Home Price Index (HPI), demonstrates that home prices continue to weaken across the U.S. Based on the HPI, existing home prices in 20 U.S. cities fell for the twelfth consecutive month in December 2007, for a year-over-year decline of 8.9 percent, a record low. The largest decline prior to December was a year-over-year 6.3 percent decline recorded in April 1991. The impact of falling home prices exacerbates mortgage default problems. Coupled with the fact that many mortgages in recent years have been issued with

[1] Inside Mortgage Finance, January 2008.
[2] LoanPerformance is a subsidiary of First American Real Estate Solutions (FARES).

"simultaneous seconds" (i.e., second mortgages issued to borrowers in lieu of the imposition of private mortgage insurance), many properties currently have high loan-to-values on the combined first and second mortgages in various parts of the country.

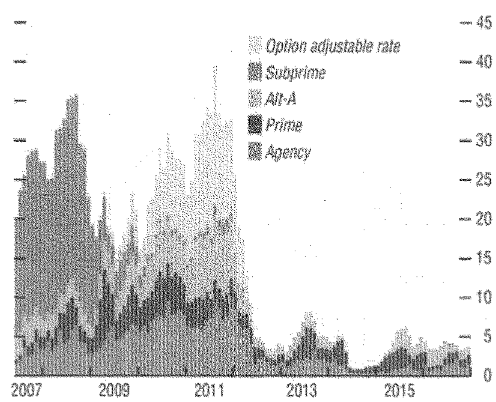
The combination of high LTV ratios and the decline in home prices is forcing many mortgages "underwater," a situation in which the borrower owes more than the home is worth. This has had a dramatic effect on increased foreclosure rates. As evidenced in the following chart from RealtyTrac.com, higher foreclosures rates are no longer isolated to the previously "hot" real estate markets, but are now evident in many areas of the country.



As can be expected, the current performance trend for residential mortgage loans is challenging. November 2007 data from LoanPerformance show marked increases in delinquencies among ARM, Alt-A and subprime loans from the previous month and year. Foreclosure rates displayed similar behavior. The bulk of 2/28 and 3/27 ARMs originated in 2005 have experienced their first rate reset and servicers are likely to have less volume over the next three months. However, there are another 1.5 million loans scheduled for rate resets in 2008, and there are many prime option ARMs approaching their first rate reset, which has the potential to produce further increases in mortgage loan delinquencies.

While there are different estimates of the projections and impact of rate resets on an already volatile housing market, we know that neither subprime nor option ARM rate resets have peaked. As the graph prepared by Credit Suisse indicates, subprime resets are expected to peak some time later this year; and option ARM resets will not peak for another several years, until some time in 2011. Coupled with the possibility that many resetting loans may already be underwater, upcoming rate resets pose serious challenges, and potential opportunities, for thrift mortgage lenders. As explained later in my statement, we believe now is the time to identify creative approaches to addressing these problems. And it is my intention that the OTS and the thrift industry play an important role in ensuring the continued viability, sustainability, and affordability of the U.S. housing markets.

Figure 1.7. Monthly Mortgage Rate Resets
(First reset in billions of U.S. dollars)

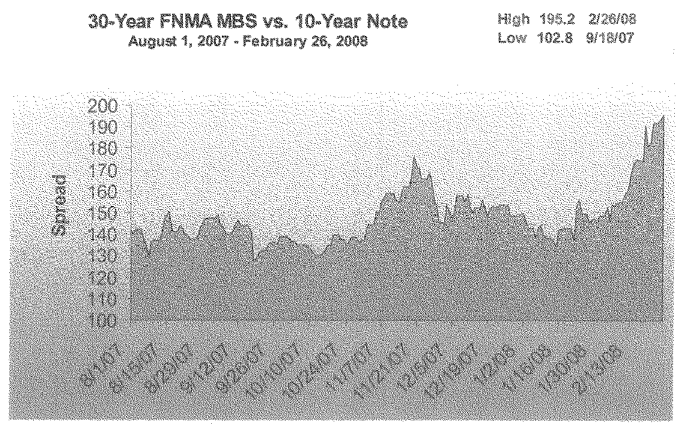


Source: Credit Suisse.

2. Thrift Industry Access to Funding

a. The Capital Markets

The capital markets continue to grapple with investor aversion to credit risk and lack of liquidity in the private label mortgage securities market. Fear of further credit losses among bond insurers and financial strain among the government-sponsored enterprises (GSEs) have contributed to higher funding costs for thrifts as investors demand higher than average yield premiums. As highlighted in the following chart, this past week the yield premium demanded for agency-issued mortgage-backed securities rose to its highest level since November 2007 (its previous peak) as investors expressed concern that future write-downs of loans could cause the GSEs to sell mortgage assets.



SOURCE: BLOOMBERG, LP

While liquidity conditions are not as strained as they were during the credit crises encountered in the summer of 2007, the demand for private label securities remains sparse. Jumbo loan-backed securities are also experiencing little demand, while liquidity for Alt-A backed securities has diminished markedly in the last two months. Investors are approaching any purchase of Alt-A backed loans with great caution due to expectations that near-term rate resets of these loans may lead to greater losses in the asset class. What this all means is that virtually all thrifts have turned back to traditional sources of funding – insured deposits and Federal Home Loan Bank advances.

b. Deposits

Insured deposits continue to be the primary funding source for thrift assets. Deposits funded 58.9 percent of industry assets at the end of 2007, down from 62.1 percent one year ago, but up from 57.1 percent at the end of 2005. In addition, the number of deposit accounts held by thrifts has trended up. Thrifts held 88.8 million deposit accounts at the end of 2007, up from 84.0 million in 2006 and 79.6 million in 2005.

c. Federal Home Loan Bank Advances

Federal Home Loan Bank (FHLB) advances increased as a funding source for thrifts in 2007 as thrifts took advantage of relatively low, long-term interest rates to secure stable sources of funds in times of uncertainty and unrest in the capital markets. FHLB advances rose to 20.0 percent of industry assets at the end of 2007, from 15.2 percent one year earlier, and from 18.7 percent at the end of 2005. Like deposits, FHLB advances continue to be an integral source of funding for thrift institutions.

3. Portfolio Limits and Diversification

a. Statutory Lending Requirements

Currently, OTS-regulated thrifts are subject to two distinct statutory restrictions on their assets. The first is a requirement that thrifts hold 65 percent of their assets in qualified thrift investments. This is a test generally intended to ensure that thrifts maintain a focus in mortgage and retail consumer lending activities. The second set of restrictions relates to specific limitations imposed on the ability of thrift institutions in various asset types, including consumer, commercial and small business lending. While there is merit for maintaining restrictions to ensure that thrift institutions remain focused on mortgage and retail consumer lending activities consistent with the underlying purpose of the thrift charter, certain asset restrictions run counter to the underlying purpose of the charter and/or draw into question safety and soundness.

For example, thrifts are currently permitted to do unlimited credit card lending, an unsecured lending activity, but are limited to 35 percent of their assets in secured consumer lending activities. This has the clearly unintended effect of promoting unsecured consumer lending activities (via a credit card) over secured consumer lending. Similarly, the existing 20 percent of assets limit imposed on thrift institution small business lending tends to discourage thrifts from pursuing business activities that could diversify their lending operations and credit risk. As described below, we have offered several legislative proposals to address these shortcomings.

b. OTS Legislative Proposals to Provide Diversification

The OTS has made recommendations to increase the ability of OTS-supervised institutions to engage in small business and consumer lending. These increases would not only strengthen OTS-regulated institutions by further diversifying their business lines, but would also increase the availability of credit in local communities. Small business lending, in particular, is a key to economic growth and recovery, particularly in low- and moderate-income areas. Earlier versions of this proposal were part of legislation passed by the House in both the 108th and 109th Congresses and we continue to seek favorable consideration of both of these proposals in the future.

In particular, we seek to broaden the ability of savings associations to engage in small business lending by either increasing the existing limit or eliminating it altogether. Alternatively, case-by-case authority granted to the OTS would permit the OTS Director to waive the (20 percent of assets) small business lending limit for institutions that can demonstrate a need for the waiver, as described below.

With respect to existing limits on secured consumer lending, this limit currently applies to all secured loans for personal, family, and household purposes. Ironically, institutions are subject to no limit on unsecured consumer credit card lending. As previously noted, this anomaly exists even though the proceeds of the loan may be used for the same purpose. Give that the current limit may actually encourage more risky lending behavior by thrift institutions, we propose eliminating the 35 percent of assets limit on secured consumer lending activities. Alternatively, as with small business lending, waiver authority could be provided to the OTS Director to waive the limit on a case-by-case basis.

If case-by-case waiver authority is provided to the OTS, both small business lending and secured consumer lending could be restricted to permit institutions to expand existing lending programs to address local, regional and national constrictions in credit availability arising from current economic conditions. The increase in lending pursuant to either of these provisions would be subject to existing safety and soundness controls and OTS oversight. OTS currently monitors these lending activities (at currently permissible levels) at all OTS-regulated institutions.

III. OTS Oversight and Supervision

A. OTS Supervisory Approach

The core mission of the OTS is to oversee and supervise U.S. thrift institutions and their holding companies, and to ensure sound consumer protections to thrift customers. The agency formulates nationwide supervision policies, procedures and guidance for its examination workforce and for the thrift industry.

Under the OTS examination strategy, agency examiners analyze the safety and soundness of financial institutions as they concurrently review institutions' compliance with regulations protecting consumers, countering terrorist financing and preventing money laundering. Each examination, as well as the agency's overall exam strategy, focuses on risk by devoting the greatest resources to the highest risk areas. The agency supports its core examination functions with monitoring, analysis, modeling and the processing of applications and other filings.

The OTS provides supervisory guidance (available on the OTS website) for examiners, thrifts and savings-and-loan holding companies on lending and appraisal practices, corporate governance, accounting, information technology and emergency preparedness. We also conduct a wide range of educational and outreach activities.

1. Interest Rate Risk Management

The risk that thrifts face from fluctuations in interest rates is a key barometer of a force that can have a deep impact on the overall health of the industry. In 1991, OTS developed a proprietary simulation tool called the Net Portfolio Value (NPV) Model to measure and monitor the interest rate risk exposure within the thrift industry. The NPV Model, as discussed in more detail below, uses detailed balance sheet information to estimate the market value of each savings association and then determines how that estimated market value is affected by changes in interest rates.

OTS recently completed a major enhancement to the NPV Model and began producing new reports using the Enhanced NPV Model. The Enhanced NPV Model provides a more accurate estimate of each institution's interest rate risk profile. More importantly, it gives OTS the ability to value a much wider range of financial instruments and the capability of producing a series of new reports that focus on areas such as net interest income, liquidity and value-at-risk. The Enhanced NPV Model solidifies OTS's position as an industry leader in the high quality measurement of interest rate risk.

2. Credit Risk Management

Thrift industry credit risk is primarily driven by the performance of residential mortgage loans; however, thrift credit exposure is not limited to the mortgage loan sector. Thrifts are also exposed to the business sector, with 3.8 percent of thrift assets held in commercial loans and another 12.3 percent of assets held in construction loans and nonresidential and multifamily mortgage loans. Further slowdowns in the economy could pressure the cash flow of commercial borrowers. We are carefully monitoring this situation within the industry. Alternatively, a steep rise in interest rates could also impact commercial borrowers, since business loans typically carry floating rates of interest. Credits highly dependent on low interest costs for positive cash flow would be most vulnerable to rapid increases in interest rates.

Credit review is a significant priority in our examination process, with the scope of our review formed by economic trends and expectations. Our analysis shows that as interest rates rise after a trough, many mortgage lenders lower credit underwriting standards to maintain high loan origination volumes. Such vintages often significantly underperform other vintages. Consequently, if rates begin to rise, OTS examiners will focus even greater attention on thrifts' underwriting processes, credit quality, reserve policies, and capital adequacy.

We are remaining vigilant in assessing the industry's credit risk exposure, particularly for institutions heavily concentrated in a very narrow product mix. We support the industry looking for ways to be less reliant on interest income. We emphasize, however, that expanding into new areas requires investment in the right people, systems, internal controls, and internal audits.

3. Compliance and Consumer Protection

Ensuring adherence to consumer protection laws is one of the primary responsibilities of the OTS. The agency meets that responsibility through a robust examination program that assesses compliance with more than 30 federal consumer protection statutes, regulations and other requirements, including the Truth in Lending Act, the Truth in Savings Act, the Real Estate Settlement Procedures Act, privacy laws and other consumer protection laws.

The OTS centralizes its compliance and consumer protection function at agency headquarters in Washington, D.C. The agency issues policies and guidance on the development, implementation and evaluation of compliance programs for OTS examiners and the thrift industry.

4. Complex and International Organizations

Historically, interest in the thrift charter has been focused primarily on entities conducting domestic consumer retail banking operations. Since the mid- to late-90s, however, a number of firms engaged in a wide range of financial services activities, both domestically and internationally, have been attracted to the charter. As a result, the OTS developed a program for supervising large and complex financial institutions. A highly experienced staff of examiners and specialists execute the program, which implements a risk-focused supervisory approach that combines on-site examination work, routine communication and off-site planning, monitoring and analysis into a single ongoing supervisory process.

Pursuant to the OTS complex and international organization program, the agency coordinates with other U.S. and international regulators to develop a comprehensive view of each firm's consolidated risk profile and financial performance. Such cooperation is essential as OTS holding companies continue to expand their international exposure.

B. Supervision and Enforcement Issues

1. Troubled Debt Restructurings

The OTS has consistently encouraged the institutions we regulate to work constructively with borrowers whose mortgage loans are in default or for which default is reasonably foreseeable. We continue to stress with the industry that prudent workout arrangements, conducted in accordance with safe and sound lending practices, are generally in the long-term best interest of both borrowers and lending institutions.

Pursuant to effective credit risk management procedures, institutions should work with borrowers to alter repayment terms, reduce interest rates, forgive principal due to a borrower's financial difficulties, or take any other steps appropriate to protect both the borrower and the institution. When modifying or restructuring existing credits, it is incumbent on an institution and our examiners to ensure that loans are properly identified, risk rated, accounted for, and reported to preserve the accuracy and integrity of financial statements. Loan modifications that are not properly accounted for will have the effect of masking delinquency and nonaccrual levels, which could lead to inaccurate ALLL calculations. While properly accounting for a troubled debt restructuring will have an impact on an institution's bottom line, it generally remains a significantly less costly alternative to foreclosure.

Many mortgages are held in securitization trusts that have outside servicers to manage the cashflows arising from the underlying mortgages. Most loan servicing agreements have been structured under the assumption that loan modifications are rare and would be pursued on a case-by-case basis. Generally, delinquent loans can be modified under this approach if the borrower demonstrates a willingness and ability to repay the loan under modified terms and it was in the best interest of the investors to modify the loan rather than foreclose. However, a loan-by-loan evaluation is very time consuming. With the rate of delinquencies in the mortgage market and the impending payment resets of various ARM products, there is little time for this type of in-depth loan-by-loan analysis. As a result, there have been a number of initiatives proposed to address this problem.

To date, there has been support for private sector initiatives to develop and implement a streamlined plan, such as articulated in the American Securitization Forum's statement of principles on this issue and the efforts of the HOPE NOW alliance, a private sector group comprising about 84 percent of subprime lenders. HOPE NOW programs include a streamlined approach to allow approximately 1.2 million subprime borrowers to be fast-tracked into affordable refinanced or modified mortgages.

While private sector programs are the lynchpin to the success of troubled debt restructurings, there are also important roles for policymakers, consumer advocates, academics and individual borrowers. Engaging all of these parties, along with industry players, is the key to resolving the many troubled mortgage loans currently outstanding or that may experience difficulties in the coming months and even several years out. It is with this in mind that the OTS proposed its ideas, discussed below, on ways to prevent avoidable foreclosures of underwater mortgage loans

2. Transparency

While OTS regulated institutions are active participants in the securitization markets, they are not typically sponsors of other structured finance products, such as structured investment vehicles (SIVs); collateralized debt obligations (CDOs); or asset-backed commercial paper (ABCP) conduits.

Where a thrift institution becomes involved in a structured finance arrangement, we will encourage greater disclosures by sponsors of, and investors in, the structured finance vehicles regarding the types of underlying assets and risks posed by the arrangement. We will also require greater disclosure of the valuation methods for the arrangement, including whether valuation estimates are derived from active or inactive markets or models. Other important factors include key assumptions and drivers of value; how such assumptions were determined; and sensitivity analysis about the impact on value if the actual results differ from the assumptions. Equally important is how risks are hedged, and the degree to which hedges were effective.

While no OTS-regulated thrifts have been required to consolidate structured finance vehicles on their balance sheets because of market illiquidity and/or credit market disruptions, these events have impacted thrift access to the capital markets. As a result, we continue to monitor this activity in the markets.

3. Enforcement Issues and Activities

When an institution's lending programs are found to be potentially predatory or lacking adequate controls to support responsible lending, there are numerous options that the OTS can take to stop these practices and correct the situation. These include formal enforcement actions and informal agreements. Our jurisdiction and oversight of an institution's lending programs also extends to the holding companies, affiliates, service providers, and other contractual relationships that an institution may utilize.

For example, we previously announced the execution of a significant formal supervisory agreement to address and remedy problems created by a subprime lending program that was conducted out of a thrift affiliate. Our action against the thrift was based on its failure to manage and control in a safe and sound manner the loan origination services outsourced to its affiliate. Our supervisory agreement required the institution to identify and provide timely assistance to borrowers who were negatively affected by the loan origination and lending practices of the thrift's affiliate and who are at risk of losing their homes in foreclosure.

Pursuant to the supervisory agreement, a reserve of $128 million was established to cover costs associated with providing affordable loans to borrowers whose creditworthiness was not adequately evaluated when their loan was originated and to reimburse borrowers who paid excessive broker or lender fees at the time of the origination. In addition, the institution agreed to increase the reserve if the costs of remediation efforts turn out to be higher than initially estimated and, in fact, the reserve has already been increased by another $35 million. Finally, the institution and its affiliates committed to donate another $15 million to be used for financial literacy programs and credit counseling.

In another case involving an institution with a high level of customer complaints regarding potentially abusive servicing practices, OTS examiners were sent to the institution to review the institution's lending practices and program. Pursuant to that review, the institution was directed to implement adequate policies to address and resolve various unacceptable lending practices. When the institution failed to address these issues in a timely manner, the OTS initiated an enforcement action against the thrift.

The institution signed a written Supervisory Agreement with the OTS in which it agreed to improve its compliance with the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act and the Fair Credit Reporting Act. In addition, the institution agreed to create a "Consumer Ombudsman" responsible for "fairly and impartially reviewing and addressing [customers'] borrowing issues in a timely and effective manner." The agreement also required the development of borrower-oriented customer service plan/practices, and a consumer dispute resolution initiative plan among other things. It is also worth noting that approximately one year following the execution of the supervisory agreement, the OTS approved the institution's request for a "voluntary dissolution."

In two other cases, similar results were achieved. Using a combination of formal and informal enforcement actions, the agency forced the discontinuation of lending operations by two federally chartered thrifts based on poorly supervised lending activities. In both cases, subprime lending programs that exhibited abusive features coupled with lax management oversight controls were effectively terminated. A significant concern by the OTS staff was an effort by both institutions to attempt to exploit the charter to engage in lending programs lacking adequate consumer protections and management controls.

In one of these cases, OTS staff shut down a program that utilized brokers to do out-of-state lending activities that were lacking sound consumer protections and controls. The agency's directive to the institution concluded that the activity was tantamount to a charter rental strategy intended to avoid State and OTS oversight of out-of-state lending activities by the institution.

We also impose conditions requiring responsible lending policies and barring abusive practices by an institution, its holding company and affiliates at the time of an acquisition. Typically, these types of conditions are appropriate when we know or have reason to believe that an acquirer plans to start or continue an existing subprime lending program at a newly acquired or de novo institution. Whenever such conditions are imposed, regional staff will work closely with and monitor the institution and its holding company/affiliates to ensure that adequate controls are imposed and maintained in connection with the subprime lending program.

We have also been vigilant in the oversight of appraisal practices within the industry. Since January 2006, the OTS has had nine formal enforcement actions addressing appraisal-related issues at OTS-regulated thrift institutions.

There are numerous other such examples of actions taken by the OTS in the course of examinations of the institutions we regulate. While we find informal actions to be an effective mechanism to address these types of supervisory concerns, we do not hesitate to use our formal enforcement authority when appropriate to do so. Fundamental to our continuing oversight of the industry we regulate is ensuring that institutions conduct their activities in a manner consistent with sound consumer protection.

4. Impact of Mortgage Market Contagion

Another issue garnering increased supervisory attention in recent months is the potential for contagion from the subprime markets affecting other sources of credit, including commercial real estate, credit card, automobile and general consumer lending, and leveraged loans. There is clearly fallout in all of these markets both from credit tightening and the adverse wealth effect that consumers are experiencing from the reduction in value of their homes, which is the biggest single asset held by many American consumers. Further exacerbating what is an already difficult credit market is the effect on institutions of turbulence in the bond insurance market, which has the potential to carry over to all aspects of the credit markets. While the current situation is presenting many challenges, OTS-regulated thrifts are responding appropriately to protect their balance sheets, but are also continuing to conduct their lending operations in a prudent and safe and sound manner.

5. Real Estate Appraisal Issues

Given the tremendous growth in originations over the last several years and increasing competition, institutions are challenged to expedite their processes and embrace, to the extent possible, available technology in providing timely underwriting decisions. Institutions are expected to insulate their real estate appraisal and evaluation function from such pressures. The OTS and the other federal banking agencies (FBAs) maintain common appraisal regulations that include minimum standards for the performance of real estate appraisals and requirements for appraiser independence.

During examinations, we scrutinize the appraisal and evaluation function as part of our overall assessment of an institution's asset quality. Institutions are expected to document all aspects of its policies and procedures, including those for obtaining appraisals and evaluations and performing pre-funding and post-audit assessments. Starting in 2003, the OTS and the other FBAs undertook efforts to address certain concerns identified during examinations. These efforts contributed to the issuance of final interagency guidance on independent appraisal and evaluation functions in October 2003, collateral credit risk management guidance for home equity lending in May 2005, frequently asked questions on the appraisal regulation in March 2005, and frequently asked questions on residential tract development lending in September 2005.

Appraisal practices continue to receive national attention from policymakers, regulators and industry groups in light of the unprecedented level of mortgage fraud cases and continued weaknesses in the U.S. housing and mortgage markets. As draft legislative provisions and other solutions for promoting mortgage quality are debated, the OTS findings suggest that current appraisal requirements and associated guidance for federally regulated institutions are appropriate for promoting sound real estate appraisal and evaluation practices. As with any processes or systems, appropriate staffing as well as effective internal controls and audits are essential. Institutions must be vigilant in obtaining accurate appraisals and evaluations and ensuring that individuals performing these valuations are independent of the loan production process.

C. Interagency Guidance

An important role of the federal banking agencies during the course of activity in the mortgage markets the past several years has been the issuance of various statements and guidance on subprime lending, non traditional mortgage products, loan modifications and mortgage servicing. This guidance, available at the OTS website at www.ots.treas.gov, includes the following:

- Illustrations of Consumer Information for Nontraditional Mortgage Products that directs financial institutions to provide clear and balanced information to help consumers make informed choices.

- Proposed Illustrations of Consumer Information for Subprime Mortgage Lending seeking comment on the illustrations to assist institutions in providing consumer information on subprime lending programs.

- Interagency Guidance for Nontraditional Mortgage Product Risks addressing supervisory concerns with the use and proliferation of certain nontraditional mortgage (NTM) products.

- Statement on Subprime Mortgage Lending to address issues relating to certain adjustable-rate mortgage (ARM) products that can cause payment shock.

- Statement on Workouts/Loan Modifications With Borrowers encouraging institutions to work with homeowners who are unable to make mortgage payments.

- Statement on Servicing for Mortgage Loans encouraging servicers of securitized residential mortgages to determine the full extent of their authority to identify borrowers at risk of default and pursue appropriate loss mitigation strategies designed to preserve homeownership.

IV. Foreclosure Prevention and Loss Mitigation Efforts

A. OTS Foreclosure Prevention Proposal

In exploring solutions to foreclosure prevention or effective loss mitigation efforts, it is important to understand the role and interests of the various participants involved in and/or affected by actions to alter the normal course of events that were anticipated when a mortgage loan was made and, in many cases, subsequently securitized. In fact, the understanding and analysis of these various relationships provides the framework for the foreclosure prevention proposal set forth by the OTS. It is important to understand these relationships in considering any solution to foreclosure prevention in the current market context.

i. Overview of Affected Parties/Participants

The first and most obvious group of affected participants is the borrowers. Even within this group, however, there may be various competing interests represented with the result that there often is not a typical borrower profile. This, of course, complicates appropriate responses and solutions aimed at assisting borrowers on a blanket or wide-scale basis. Generally, borrowers can be sub-grouped into three broad classes:

- Borrowers not able to sustain the financial demands of homeownership;

- Borrowers who can be helped, and who were put into their current situation because they were victims of predatory lending, poor loan advice, or poor judgment on their own part; and

- Borrowers who can be helped, and were put into their current situation because of a change in their personal circumstances and now require payment flexibility to get back on their feet.

The next most obvious group of participants in the process is lenders. Within this group, there are generally two sub-groups – portfolio lenders and lenders who originated for sale into the secondary market. While it is relatively straightforward to understand the interests of a portfolio lender, the interests of lenders who originated for sale may be more difficult to gauge. For example, originators that maintained good documentation and underwriting standards will generally be able to approach any solutions with the knowledge that they can do so from a position of relative strength given potential litigation risks. In contrast, originators that failed to document and/or conduct good underwriting may be forced into solutions that are not optimal for them (and sometimes even the borrower) because of the threat of litigation.

The next group of participants with a keen interest in any potential foreclosure prevention of loss mitigation activities is investors in the securitization. Again, there are multiple layers or sub-groups within this group of participants in a securitization. A typical securitization has a number of different investor types with differing risk profiles, return expectations, and interests in the securitization. For example, there will be the highest rated investors who have agreed to take a lesser return and assume a lower risk profile in exchange for a more stable and predictable income stream. Next, the typical securitization will have a mezzanine tranche of investors who have a more elevated risk profile than the AAA (highest rated) investors, but who also expect a certain return on their investment in the securitization. Finally, at the other extreme are the residual owners or investors in the securitization. These investors bought into the deal with the understanding that they had the potential for significantly high returns if the securitization performed as expected, but they would also take the first losses if the securitization did not perform as expected.

Next, we have the interests of the securitizers, as well as the trustee of the trust established to hold the mortgages pursuant to the securitization. While the interests of these two groups are not clearly aligned, both will attempt to ensure that the best interests of the investors are served. While the trustee will pursue this agenda with the understanding that it has a fiduciary duty to the investors to do so, it is sometimes confusing to figure out exactly how this fiduciary duty may be served in protecting the interests of different types of investors in the securitization. In contrast, the securitizer will typically attempt to make sure that a securitization remains intact to avoid litigation exposure and potential tax and accounting issues arising from its initial actions in establishing the securitization.

Finally, perhaps the most complicated and complex interest in a securitization is that of the servicer whose job it is to make sure the mortgage loans perform and payments are made to the mortgage trust based on the timetable established in the securitization. In effect, the servicer is the banker as well as bill collector for the securitization. In this regard, the role of the servicer is critical to the success and continued viability of a securitization. For the same reason, the servicer also figures prominently in any efforts to prevent foreclosures of mortgage loans held by the trust, as well as in loan modification and loss mitigation efforts to keep borrowers in their homes. Providing proper financial incentives and/or aligning the interests of the servicer with the other parties in a securitization is, we believe, an important key to the success of any foreclosure prevention or loss mitigation program.

ii. The OTS Proposal

In examining the various issues in the current market context, the OTS set out to identify and address what it perceives to be the most significant problem in today's housing market. In our view, this problem is avoiding foreclosures of owner-occupied properties held in securitizations where a distressed borrower – including a borrower facing an insurmountable reset – is unable to refinance a loan because the fair market value of the property is less than the current outstanding loan amount.

In pursuing a solution to this problem, we had a number of objectives. First, we were seeking to identify a market-driven solution that relies on existing (or already proposed) programs and avoids a new government guarantee or assistance. We also wanted to ensure that any solution minimizes motivations for "gaming" the system by borrowers currently able to pay under their existing loan. Similarly, we sought to avoid providing a windfall to borrowers and investors in the securitization. And we were attempting to identify a solution that optimizes servicer incentives to seek it out and investor incentives and motivations to accept it.

Finally, we sought to ensure that the solution that we identified to meet these objectives involves implementing a program in which OTS-regulated institutions could actively participate, along with other lenders, without taking additional, undue risks onto their balance sheets.

Pursuant to the OTS proposal, depository institutions would offer and underwrite FHA-insured loans (i.e., under the FHA's existing standards and FHA programs already in place) based on the current fair market value of the property. Depending on how a program is structured, such loans could be at the FHA-insured maximum 97 percent LTV ratio, or a lesser percentage LTV. The proceeds of the new FHA-insured loan would then be used to provide a partial pay-off of the outstanding balance of original mortgage loan to the holder of that loan. And, finally, the key to all of this is that the original investors would receive a "negative equity interest" (e.g., a negative equity certificate representing an interest in the negative equity) in the difference between partial pay-off (from the FHA-insured loan) and the balance of the original mortgage loan held in the securitization pool.

As we have structured the proposal, upon the subsequent sale of the property by the borrower, any appreciation in the value of the property (reflected in the sale price) above the discounted payout (i.e., the amount paid to the investors with the proceeds of the FHA-insured loan) would be payable to the investors up to the full amount of the negative equity interest held by the investors, with any sale proceeds beyond that amount being payable back to the borrower.

Finally, we have had numerous discussions with policymakers over the past few weeks and several additional ideas have come out of these discussions that we believe may provide useful refinements to the proposal. Chief among these is the idea that the negative equity interest created under the proposal could be shared among the existing holders of the loan currently in the securitization, the FHA or other government entity (recognizing the government's interest arising from FHA's insurance, which is a critical component of the program), and even the borrower/homeowner to maintain appropriate incentives if the value of the property eventually begins to appreciate and puts the negative equity interest "in the money." On this latter point, giving the homeowner even a nominal amount in the upside appreciation of the property will keep intact incentives for the borrower to maximize value on resale and continue to maintain the property.

Another concept that has been broached recently is the idea that it may make more sense from the standpoint of the FHA's interest in maximizing its existing resources and risk exposure to have a program in which the new FHA-insured loan is at a LTV ratio less than the current 97 percent maximum permitted by the FHA (e.g., a 90 percent LTV). Depending on the risk profile of the borrower and the nature of the real estate market in which the property securing the mortgage is located, the FHA may choose to tighten its standards (by lowering the LTV ratio) and/or structuring its insurance premiums to mitigate increased risk exposure. Under this scenario, as with the full 97 percent LTV, the difference between the old loan and the new loan would be allocated to the negative equity interest or certificate representing that interest.

We are continuing to work with policymakers and industry officials to identify issues and potential weaknesses in our proposal, as well as to make further refinements to improve it. Our goals and underlying rationale for the proposal remain:

- Providing a market-driven solution that does not "bail out" investors or borrowers, but rather promotes responsible lender and borrower behavior;
- Requiring investors to take a lesser amount at payout, but not a dramatically reduced recovery such as that in a foreclosure of the original loan (thereby providing incentives for investors to pursue the program);
- Avoiding a windfall to borrowers by requiring appreciation in a subsequent sale to be paid to investors up to the amount of the negative equity interest

(perhaps adjusted for borrower incentives paid out of the negative equity interest in order to protect underlying property valuation);

- Relying on existing FHA and similar programs – including FHA-insurance – to help in resolving problem loans in securitizations;
- Creating a potentially marketable financial instrument in the negative equity interest that could be tradable;
- Providing adequate and proper incentives for servicers to implement foreclosure prevention programs that are in the best interests of investors and borrowers (and acceptable to investors);
- Maintaining the integrity of the securitization structure and terms of the pooling and servicing agreement with minimal disruption to the mortgage securities market; and
- To the extent practicable, identifying a tax-neutral solution that does not involve forgiveness of debt and thereby create an immediate taxable event for a borrower.

B. Loan Modifications and Workouts

One of the most important considerations in structuring a viable loan modification program is reaching as many borrowers as possible as quickly as possible. In our view, this translates into conducting an expeditious and systematic review of outstanding loans approaching reset – or for which a rate reset has already occurred – in order to identify broad categories of borrowers eligible for loan modifications. As simple as this concept sounds, in application it has many challenges. I believe it is critical in this effort to provide servicers with as much guidance and flexibility as practicable to conduct meaningful reviews to identify borrowers in need of assistance.

In structuring a viable loan modification program, three goals should be recognized and incorporated. First, and most fundamental, the program should preserve and sustain homeownership. Second, of course, the program should protect homeowners from avoidable foreclosures due to interest rate resets. Finally, it is extremely important that the program be structured to preserve and maintain market integrity, as well as ensure the continued safety and soundness of depository institutions and the broader financial services industry.

Currently, about two million American families have subprime 2/28 and 3/27 mortgages that are scheduled to reset by the end of 2008. The initial "starter rate" for these loans typically ranged from 7 percent to 9 percent; and about 30 percent of delinquent 2/28 and 3/27 loans were past due before the rate reset. Between 1980 and

2000, the national foreclosure rate was below 0.5 percent of aggregate mortgage loans. In fact, as recently as 2005, the national foreclosure rate stood at 0.38 percent. Since then, the foreclosure rate has risen 55 percent to almost 0.6 percent of outstanding mortgage loans. Far more troubling is that, among subprime borrowers holding a 2/28 or 3/27 loan product, foreclosures are projected to rise from about 6 percent currently to about 10 percent by 2009.

There are several important factors in structuring a viable loan modification program that can influence these projections downward. First, as I note at the outset, expediency is critical. Servicers should quickly review their loan portfolios to identify characteristics of groups of borrowers eligible for loan modifications. Eligibility standards will determine the likelihood of achieving meaningful impact under a loan modification program. Generally, borrowers should be eligible if, due to rate resets, they are either in default, or there is a reasonable foreseeability of default.

A program's success will also hinge on providing adequate time for troubled borrowers to work out of their current economic problems. We believe servicers should be prepared to extend the starter rate for a minimum of 36 months, but a good argument can be made for a minimum of five years. And it may also make sense to include a trial period, such as six months, for certain borrowers to be able to demonstrate that they can continue to pay under the starter rate before the starter rate is locked in under a loan modification. Generally, a trial period will serve to protect the interests of the lenders, avoid including in a modification program loans that are destined to fail, and provide resolution to borrowers rather than delaying the inevitable for an additional 36 months or longer.

We are aware of a number of loan modification programs that have already been established. While these programs have been in place for generally short periods of time, i.e., several months, it is our understanding that strategies similar to those articulated above have been successfully deployed to modify significant numbers and dollar amounts of subprime 2/28 and 3/27 loans held in securitizations. For example, several programs have employed broad-based borrower identification criteria to identify groups or classes of loans at risk, and then applied established eligibility requirements to hone in on individual loans and borrowers at risk of default. Other programs have opted for more comprehensive fixes by identifying borrowers and re-underwriting with full documentation for a 30 year term. We are supportive of all of these programs and efforts to address the problem and encourage that any standards or guidelines provide maximum flexibility to servicers and lenders to address troubled subprime loans in a manner that protects both the borrowers and the underlying economic interests of investors.

It is also critical in exploring viable solutions that our actions preserve the integrity of the broader mortgage markets, including capital market participation in the continued funding of the mortgage markets. While there have been some who have suggested that solutions from the capital markets have fueled speculative and unsafe mortgage lending activities, there remain many U.S. consumers who are homeowners solely because of favorable mortgage rates and terms that they received as a result of the efficiency of the U.S. capital markets. In other words, we must take great care that our efforts on behalf of some consumers who entered into bad deals do not compromise the greater, collective interests of all consumers. It would be a policy failure to produce a result that alters mortgage funding so that the future cost or availability of mortgage credit is adversely affected for all U.S. consumers.

We are currently at what can best be described as a crossroads to addressing the wave of rate resets for subprime 2/28 and 3/27 mortgage loans. There are a number of programs that have been reasonably successful in structuring viable loan modification approaches, but more needs to be done – and soon.

As recently reported, there have been significant industry efforts to identify practices and approaches to structure guidelines for viable loan modification programs that can be implemented quickly, efficiently and effectively in the marketplace. Our understanding is that many of the issues previously identified as significant obstacles to broad-scale loan modifications may, in fact, be issues that can be addressed within the terms of the pooling and servicing agreements that dictate the rights of servicers and impact on investors under terms of the trusts that hold the securitized assets. Given this, we believe that legislative and/or regulatory actions could hinder rather than help at this point in the process. Instead, we encourage the industry to identify and implement solutions that work, with the full understanding that regulatory intervention will occur quickly if it becomes clear that any proposed solution(s) will not be effective.

V. Strengthening Consumer Protections in the Mortgage Markets

For most Americans, a home is their single largest investment, as well as the single largest debt obligation they will incur during their lifetime. However, many of the types of fundamental consumer protections in place with respect to investing in the securities markets or depositing your money at a financial institution are not paralleled when it comes to investing in a home. In our view, strengthening consumer protections in the mortgage markets not only protects borrowers, it also protects lenders and all other participants in the mortgage process from the types of market meltdown and contagion we are currently experiencing.

There have been a number of suggestions for improving protections for homebuyers/borrowers that are important in understanding how we can improve the mortgage markets. These include two regulatory initiatives, the OTS Unfair or Deceptive Acts or Practices (UDAP) proposal and the Federal Reserve Board's Regulation Z proposal; a separate OTS proposal aimed at tightening federal regulation and oversight of mortgage banks and originators; and various legislative proposals, including your bill, Mr. Chairman, S. 2452, the Homeownership Preservation and Protection Act of 2007, which would reform and bolster existing consumer protections in the mortgage markets.

A. The OTS UDAP Proposal

On August 6, 2007, the OTS issued an Advance Notice of Proposed Rulemaking (ANPR) requesting comment on the issuance of additional OTS regulations implementing section 5 of the Federal Trade Commission Act, which prohibits unfair or deceptive acts or practices (UDAPs). The ANPR solicited comment on a wide range of potential UDAPs in addition to those already covered by the existing OTS Credit Practices Rule.

Based on our review of comments from consumer advocates, industry representatives, members of Congress, and the general public, we are working to issue a Notice of Proposed Rulemaking (NPR) in the near future. We expect the UDAP rule will address certain practices that have raised concern, including retroactive rate increases and double cycle billing. In response to commenters' requests for consistent interagency standards and an even playing field, we have invited the other federal agencies with FTC Act rulemaking authority – the Federal Reserve Board, Federal Trade Commission, and National Credit Union Administration – to participate in the rulemaking. Our goal is to issue an interagency proposal this spring.

B. The FRB's Regulation Z Proposal

Another regulatory proposal aimed at addressing certain consumer protection issues in the mortgage markets that have been prominently highlighted in recent years is the FRB's Regulation Z proposed rulemaking. Under the amendments proposed to Regulation Z by the FRB, a new category of "higher-priced mortgages" would be established with additional consumer protections. These would include a requirement to assess a borrower's ability to repay a loan, limits on prepayment penalties, and escrow requirements. In addition, the proposal would impose certain requirements on all mortgages, including severe restrictions on yield spread premiums, appraisal standards, and barring certain predatory billing and deceptive advertising practices.

Without commenting on the specifics of the FRB's proposal, we are supportive of its efforts to address consumer protection deficiencies in our current mortgage market. As I noted earlier, correcting such deficiencies will benefit all market participants and the overall health and stability of the housing and mortgage markets.

C. S. 2452 and Other Pending Legislative Proposals

We have also reviewed your legislative proposal, Mr. Chairman, S. 2452, the Homeownership Preservation and Protection Act of 2007, which would reform and bolster existing consumer protections in our mortgage market. Your bill would expand protections and coverage for high cost loans, including restricting the financing of points and fees; barring prepayment penalties, yield spread premiums and balloon payments; and requiring a "net tangible benefit" to the borrower of a high cost loan.

Like H.R. 3915, the House-passed mortgage reform bill, your legislation would subject most non-prime loans to certain requirements, including demonstration of an ability to pay the loan. It would also impose certain duties on lenders and other participants in the mortgage process in their dealings with borrowers.

While we are continuing to study the potential impact on the mortgage markets of your proposal, Mr. Chairman, that are two remaining provisions of the bill that deserve mention and serious consideration in any mortgage reform legislation. These are the foreclosure prevention counseling requirements, and extending to the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation authority to issue regulations under section 5 of the FTC Act (i.e., UDAP regulatory authority).

I look forward to working with you, Mr. Chairman, on S. 2452 and all other relevant legislative proposals to amend, revise and/or reform our mortgage system.

D. Federal Regulation and Oversight of Mortgage Banks and Brokers

At the OTS, we focus our regulatory approach on maintaining a mortgage lending industry that complies with applicable consumer protection laws and regulations. We strive to achieve these objectives with a minimum of burden on the industry and with expert staff that have a unique understanding of the financial services and mortgage industries. We support private sector solutions that promote innovation and competition over excessive regulation, but we also ensure that OTS staff are fully engaged and committed to our mission of protecting the safety and soundness of the institutions we supervise, examining for compliance with consumer protection laws, and encouraging a competitive industry that meets the financial services needs of its customers.

A prominent issue in the in the context of the current mortgage market situation has been the lack of meaningful oversight of certain key players in the mortgage process. While there has been a lot of attention directed at bolstering oversight of mortgage brokers and originators – which we strongly support – we also believe federal oversight of the entities that fund the mortgage process would be beneficial. It is critical to ensure that mortgage banks be forced to compete by the same set of standards as insured depository institutions.

Establishing a partnership between the states and a federal overseer to set and enforce minimum mortgage funding standards would ensure accountability and consistency throughout the mortgage lending process. This would be similar to the partnership that exists between the FDIC and state banking commissioners in the oversight of state-chartered banks. Such a partnership need not involve establishing a federal mortgage banking charter, but rather a federal-state partnership to regulate these entities and ensure nationwide uniformity.

The OTS has extensive expertise in the oversight and supervision of mortgage banking operations, as well as mortgage originators, that I believe would benefit both the mortgage origination process and the currently unregulated mortgage banking market.

While it is not my intention to expand our regulatory authority, the OTS is in a unique and skilled position to help level the playing field by acting as a backstop for state licensing and registration for originators, as well as participating in a prudential federal-state supervision of state mortgage bankers who fund mortgages. If Congress determined that the OTS could provide the best solution by taking on these responsibilities, we would assume these duties by applying a wealth of institutional knowledge and experience supervising and regulating all aspects of the mortgage markets.

VI. Conclusion

Thank you, Mr. Chairman, Senator Shelby and Members of the Committee, for the opportunity to testify on behalf of the OTS on the current condition of the thrift industry and on various OTS proposals to address existing issues and problems in the mortgage markets.

As detailed in my statement, disruptions in the mortgage markets are having a significant impact on the financial condition of the thrift industry; however, the industry's capitalization remains strong and asset quality is relatively stable. We continue to monitor industry exposure to the fallout from problems in the subprime lending market; and we are also closely monitoring thrift industry exposure to upcoming resets on prime option ARMs that are expected to occur in the next several years.

We are also continuing to study various issues and problems in the mortgage markets that are affecting thrift lenders and other market participants. Among the solutions that we believe have merit are a foreclosure prevention proposal to keep distressed borrowers in their homes by partially paying off their current "underwater" mortgages with an FHA-insured loan and allocating the balance to a negative equity interest that would pay out in the event of future appreciation upon sale of the property. We also encourage the Committee to consider OTS-proposed legislation that would permit thrift institutions greater diversification of their assets into small business and consumer lending activities. Finally, we encourage the Committee to consider legislation to provide federal oversight and regulation of mortgage banks and brokers, including whether the OTS could provide the best solution by taking on these responsibilities.

We look forward to working with you, Mr. Chairman, Senator Shelby and the Members of the Committee to address the current and upcoming challenges in the mortgage markets. Thank you.

STATEMENT

OF

THE HONORABLE JOANN M. JOHNSON
CHAIRMAN
NATIONAL CREDIT UNION ADMINISTRATION

"CONDITION OF THE BANKING INDUSTRY"

BEFORE THE

UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

TUESDAY, MARCH 4, 2008

I. Introduction

The National Credit Union Administration (NCUA) appreciates this opportunity to provide agency views on "The State of the Banking Industry." The federally insured credit union industry comprises a relatively small but important part of the financial institution community, and NCUA's perspective on the financial performance of the institutions the agency regulates and insures will hopefully add to the overall understanding of a wide range of issues. Despite the dislocations in the credit markets, and the attendant effect on the mortgage industry and now the broader economy, the federally insured credit union industry continues to be financially strong. NCUA is very aware of the need for close and diligent regulatory oversight in the context of the difficult environment cited above.

NCUA's primary mission is to ensure the safety and soundness of federally-insured credit unions. It performs this important public function by examining all federal credit unions, participating in the supervision of federally insured state chartered credit unions in coordination with state regulators, and insuring federally insured credit union member accounts. In its statutory role as the administrator for the National Credit Union Share Insurance Fund, NCUA provides oversight and supervision to 8,101 federally insured credit unions, representing 98 percent of all credit unions and approximately 87 million members.[1]

[1] Approximately 170 state-chartered credit unions are privately insured and are not subject to NCUA oversight.

II. Financial Status of the Credit Union Industry

The financial state of the federally insured credit union industry remains strong and healthy with financial trends indicating a safe and sound industry. The following discussion highlights key operating trends and supports the conclusion that federally insured credit unions have heeded NCUA's guidance issued to date, particularly related to the risks associated with real estate lending, and are well positioned to weather the current downturn in the economy.

Federally Insured Credit Unions Experience Continued Growth in Assets and Shares

Aggregate assets of federally insured credit unions increased $43.46 billion, or 6.12 percent, to a new high of $753.46 billion. Federally insured credit unions continue to focus priority on meeting the lending needs of the membership as net loans comprise 70 percent of total assets.

Total shares grew 5.19 percent in 2007 to $632 billion. Strong growth in money market shares, IRA/KEOGH accounts, and certificates accounted for the majority of the growth. 2007 also marked the third consecutive year regular shares experienced negative growth, and the second consecutive year-end reporting period that total share certificates represented the largest category of total shares.

Federally Insured Credit Unions Continue to Provide Members with a Full Range of Loan Products

Loans continue to be the largest federally insured credit union balance sheet item, representing an industry-wide commitment to providing members with a full range of lending products and services. At the end of 2007, net loans represented 69.42 percent of aggregate credit union assets. Additionally, loan growth outpaced share growth in 2007, with total loans increasing $32.5 billion, resulting in a loan-to-share ratio of 83.3 percent – compared to a 10-year average loan-to-share ratio of 76.3 percent. As with 2006, real estate loans accounted for the majority of all loan growth in 2007, and represent 51.45 percent of total loans. During 2007, fixed rate first mortgages increased 14.40 percent or $13.08 billion, and adjustable rate first mortgages increased 9.49 percent, or $6.54 billion.

Delinquency and Net Loan Losses Have Increased in the Current Environment

As this document will highlight, federally insured credit unions have appropriately positioned themselves to withstand the current economic cycle and related mortgage lending crisis. However, the federally insured credit union industry is not immune to the macro economic impact of increasing credit risk exposure created by the current housing market. After several years of declining delinquency levels, 2007 saw an increase in the aggregate delinquent loan ratio. Aggregate delinquency increased from .68 percent to .93 percent of total loans outstanding. In comparing the various categories of delinquent loans (2-6 months, 6-12 months, and greater than 12 months), NCUA recognizes an increase in the dollar amount of delinquent loans in the 2-6 month category over the last several years. The dollar amount of loans in the 6-12 month category increased in 2007 after maintaining a consistent level dating back to 2002. Similarly, the dollar amount of delinquent loans greater than 12 months delinquent have remained stable during this same time period.

Focusing more closely at delinquent real estate loans in particular, federally insured credit unions saw real estate delinquency nearly double in 2007, albeit from only .34 percent to only .67 percent. While this amount represents a high watermark for mortgage delinquency in the last 13 years, it is important to note that federally insured credit unions have demonstrated an ability to weather economic storms in the past as they did when federally insured credit union mortgage delinquency hit a high of .56 percent back in 1995.

The largest area of concern within the category of real estate loans is the increase in the category of Other Real Estate Adjustable Rate Loans, mostly made up of Home Equity Lines of Credit (HELOCs). Delinquency for this category increased from .36 percent in 2006 to .80 in 2007.

Not surprisingly, the aggregate net charge-off ratio for all loans also increased during 2007, albeit only 5 basis points to .50 percent of average loans. Looking more closely at just real estate loans, NCUA noted an increase in net charge offs from .03 percent in 2006 to .08 percent in 2007; with the majority of the increase identified as Other Real

Estate Loans (HELOCs/Second Deed of Trust). This trend broke a 4-year span of net real estate loan losses alternating between .02-.03 percent of average real estate loans.

Federally Insured Credit Unions Reporting Real Estate Foreclosures Up in 2007

To facilitate better risk identification and monitoring, NCUA began collecting data on foreclosed real estate with the June 2006 Call Report cycle. Call Report data shows foreclosure trends have been increasing each quarter to a high of $332 million as of year-end 2007. Consistent with what has been observed nationwide, data supports the last half of 2007 was especially challenging for federally insured credit unions and consumers as foreclosures increased 28 percent and 22 percent for the quarters ending September 30, 2007 and December 31, 2007 respectively.

Higher Provision for Loan and Lease Losses Impacted Earnings in 2007

The level of earnings for federally insured credit unions declined further in 2007, to .65 percent of average assets. This decline was largely due to an increased Provision for Loan and Lease Losses expense needed to adequately fund for estimated losses in the lending portfolio based on the current environment. This level of return, however, was more than sufficient to cover the cost of operations and contribute to the already solid level of net worth. This is consistent with NCUA's commitment to focus examination and supervision efforts on a federally insured credit union's ability to build capital to meet members' needs, and not just obtain an arbitrary level of return which may sacrifice service to the membership. This philosophy on evaluating earnings was presented to examiners and federal credit unions in Letter to Credit Unions 06-FCU-04 in August of 2006.

Federally Insured Credit Unions Have Strong Net Worth

Aggregate net worth increased $4.32 billion, or 5.28 percent, in 2007 to $86.25 billion, representing the highest dollar level in credit union history. Although asset growth outpaced capital growth in 2007, thereby diluting the industry net worth ratio to 11.44 percent of total assets, the overwhelming majority of federally insured credit unions remain very well capitalized. In fact, as of December 31, 2007, 99.34 percent of all federally insured credit unions were at least "adequately capitalized" or better, with 98.6 percent of all federally insured credit unions "well capitalized".[2]

Looking Forward

In addition to evaluating standard risk trend reports each quarter, NCUA will be monitoring an increasing trend in activity of consumer credit card loans as well as delinquent credit card loans. As of December 2007, credit card loan delinquency was 1.33 percent, nearly reaching a high reported back in 2003. This could be an indicator of consumers facing financial difficulties and needing to access the only readily available cash source, particularly now that access to additional cash through HELOCs may have been cut off or significantly reduced. NCUA will continue to monitor this

[2] NCUA's Prompt Corrective Action (PCA) framework utilizes a statutory net worth category classification to include: "Well Capitalized" for credit unions with a total net worth ratio of 7 percent or above, "Adequately Capitalized" for credit unions with a total net worth ratio of 6 – 6.99 percent, "Undercapitalized" for credit unions with a total net worth ratio of 4 – 5.99 percent, "Significantly Undercapitalized" for credit unions with a total net worth ratio of 2 – 3.99 percent, and "Critically Undercapitalized" for credit unions with a total net worth ratio of less than 2 percent. NCUA utilizes a modified version of this matrix for newly-chartered credit unions.

apparent trend over the next several Call Report cycles and provide relevant guidance to the industry and agency staff if warranted.

III. Mortgage Lending in the Federally Insured Credit Union Industry

A Closer Look at the Current State of Federally Insured Credit Union Mortgage Lending

As a point of reference, during 2007, the Mortgage Bankers Association estimated first mortgage loan originations in the marketplace of over $2.33 trillion, of which federally insured credit unions originated only 2.53 percent or $59 billion first mortgage loans.[3] First mortgage loans in federally insured credit unions represent only 7.40 percent of mortgage loans outstanding in all federally insured depository institutions.[4]

In considering trends related to all mortgage loans, 70 percent of federally insured credit unions offer mortgage loans to their members. Those not offering mortgage loans are generally smaller credit unions that cannot afford the expertise or infrastructure to grant mortgages or manage mortgage portfolios. Additionally, smaller federal credit unions have difficulty implementing a wide range of mortgage products since loans to a single member are statutorily limited to 10 percent of a federal credit union's total unimpaired capital and surplus.[5] Consequently, the majority of federally insured credit union

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[3] Based on information available at the Mortgage Bankers Association website for 2007 Purchase and Refinance Originations http://www.mbaa.org/files/Bulletin/InternalResource/60108 .pdf.

[4] NCUA data and *FDIC- Statistics on Depository Institutions Report, 1-4 Family Residential Net Loans and Leases for all depository insured institutions as of 9/30/2007.* 30 Sept. 2007. Federal Deposit Insurance Corporation. < http://www2.fdic.gov/SDI/SOB>.

[5] 12 C.F.R. 701.21(c)(5). Unimpaired capital and surplus equals shares plus post-closing, undivided earnings.

mortgage lending occurs in larger federally insured credit unions, as the following chart illustrates:

Federally Insured Credit Unions by Asset Size	**Number of Mortgage Loans Originated in 2007**	**% of Federally Insured Credit Union Mortgage Loan Portfolio as of 12/31/2007**
Greater than $1 billion	494,526	46.86%
$500 million-$1 billion	214,743	16.89%
$50 million-$500 million	485,256	30.85%
$10 million-$50 million	84,087	4.98%
Less than $10 million	7,366	0.42%

Demand for mortgage loans in federally insured credit unions remains high. As mentioned earlier, mortgage loans led all loan types in growth in 2007, increasing $27 billion (83 percent of all loan growth) to a new high of 51 percent of total loans. NCUA continues to closely watch performance indicators in the mortgage lending area through data collection and the examination and supervision process.

As the following chart demonstrates, the majority of mortgage loans in federally insured credit unions are fixed rate, with almost all of the remainder being standard adjustable rate mortgages. Nontraditional mortgages are offered by less than 6 percent of federally insured credit unions and represent just over 2 percent of mortgage loans outstanding.

Type of Mortgage	Dollar Amount of Mortgage Loan Portfolio (billions)	% of Federally Insured Credit Union Mortgage Loan Portfolio as of 12/31/2007
Fixed Rate	$157	57.9%
Adjustable Rate	$114	42.1%
Interest Only or Payment Option[6]	$6.3	2.3%

Fixed rate mortgage loans accounted for 77.5 percent of the increase in mortgage loans during 2007. Fixed rate mortgages in federally insured credit unions grew at a rate of 15.3 percent during 2007. Adjustable rate mortgage loans accounted for 22.5 percent of the increase in mortgage loans during 2007, and grew at a rate of 5.6 percent. This indicates a clear preference by federally insured credit union members for fixed rate mortgage loans in the current economic environment, and likely includes a significant degree of refinancing of adjustable rate mortgages.

Nontraditional Mortgage Lending in Federally Insured Credit Unions

Recognizing the increase in nontraditional mortgage products in the broader market (also referred to as "exotic," or "alternative" mortgage products), NCUA amended the 5300 Call Report to collect data on certain nontraditional first mortgage loans. Results

[6] NCUA does not capture information relating to the type (fixed or adjustable) of "interest-only" or "payment-option" loans, just the dollar amount outstanding for these loan products. This amount is reflected in the totals for both fixed and adjustable rate mortgage loans outstanding.

for these mortgage products became available with the March 2007 reporting cycle.[7] The data indicates that these mortgage products (specifically "Interest-Only" or "Payment Option" mortgages) are only offered in a small number of federally insured credit unions and comprise a very small portion of the total mortgage portfolio.

As the following table indicates, federally insured credit unions typically grant traditional mortgage loans:

Types of Federally Insured Credit Union Real Estate Loans[8]					
Quarter Ending:	**Dec-06**	**Mar-07**	**Jun-07**	**Sep-07**	**Dec-07**
Total Fixed Rate First Mortgages	37.2%	37.6%	38.3%	38.2%	38.4%
Total Balloon/Hybrid First Mortgages	16.9%	17.1%	16.9%	17.1%	17.2%
Total Adjustable First Mortgages	11.3%	11.1%	11.0%	10.8%	10.6%
Total Other Real Estate	34.6%	34.2%	33.8%	33.9%	33.8%
Total Real Estate Loans	100.0%	100.0%	100.0%	100.0%	100.0%
Non-Traditional: Interest Only/Optional Payment Loans[9]	N/A	1.9%	1.8%	2.1%	2.3%

The non-traditional loans (Interest Only/Optional Payment Loans) only make up about 2.3 percent of total real estate loans outstanding and .83 percent of total assets.

There are several reasons why these riskier mortgage loans are not prevalent in federally insured credit unions. As earlier addressed, many federally insured credit unions are smaller institutions that lack the sophistication or resources to underwrite

[7] NCUA's 5300 Call Report is the data collection tool used to collect required financial statement reports from federally insured credit unions on a quarterly basis.
[8] The table reflects the percentage of each real estate loan type to total outstanding real estate loans.
[9] NCUA only captures the balance of Interest Only/Optional Payment Loans and does not distinguish the type of such loans. Therefore, the Interest Only/Optional Payment Loans dollars are intermixed into the various types of loans listed in the table.

these types of loans. Also, as member-owned not-for-profit cooperatives, federally insured credit unions lending motivation is designed to be member-oriented, appropriately concerned with the suitability and impact on the member. In addition, the Federal Credit Union Act prohibits prepayment penalties and establishes a statutory limit for interest rates.[10] Because of these statutory provisions, the regulatory environment for federal credit unions is not conducive to some of the features that make the cost of underwriting these loans more tenable to other types of institutions.

Mortgage Loan Performance

Over the last decade, aggregate mortgage delinquency as been very low, averaging only .38 percent and mortgage loan losses has been equally low at .04 percent even with the increased numbers associated with these trends in 2007. Real estate delinquency did increase in 2007; however, it still remains at a manageable level.

Real Estate Loan Delinquency > 2 Months					
Quarter End:	**Dec-06**	**Mar-07**	**Jun-07**	**Sep-07**	**Dec-07**
1st Mortgage Fixed/Total 1st Mtg Fixed Loans	0.28%	0.28%	0.36%	0.44%	0.48%
1st Mortgage Adjustable Rate/Total 1st Mtg Adjustable Rate Loans	0.33%	0.31%	0.33%	0.46%	0.69%
Interest Only & Payment Option First Mortgage/Total Int Only and Pmt Opt First Mtg Loans	N/A	0.34%	0.34%	0.88%	1.66%

[10] The Federal Credit Union Act establishes a limit of 15% per annum inclusive of all service charges, with authority for the NCUA Board to establish a higher ceiling when certain economic conditions are met. The ceiling is currently set at 18%. 12 U.S.C. §§1757(5)(A)(vii) and 1757(5)(A)(viii).

As noted in the table above, nontraditional loans (interest only and optional payment loans) experienced an increase in delinquency. Federally insured credit unions will continue to manage this increase through their existing collection policies and procedures. NCUA examiners will review federally insured credit union delinquency control efforts during their examinations and, when needed, issue Documents of Resolution with federally insured credit union officials to ensure proper controls are in place.

Credit unions typically have also experienced low real estate foreclosure rates as demonstrated in following table:

Foreclosed Real Estate					
Quarter Ending:	**Dec-06**	**Mar-07**	**Jun-07**	**Sep-07**	**Dec-07**
Amount (in Millions)	164.1	190.2	213.4	271.8	331.9
Percentage Increase	14.11%	15.93%	12.17%	27.40%	22.11
Percentage of Total Real Estate Loans Outstanding	0.07%	0.08%	0.08%	0.10%	0.12%

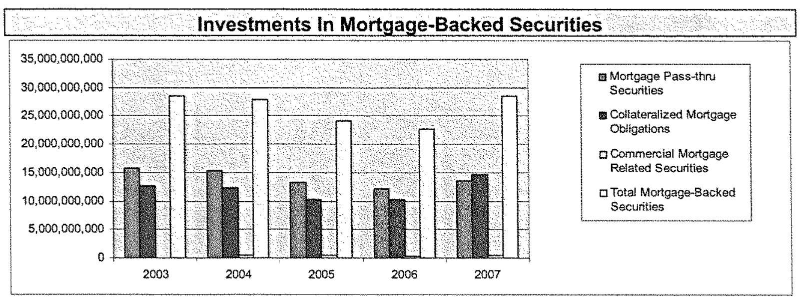
Although there has been a significant percentage increase in total real estate foreclosures in 2007, the actual dollar amount of $332 million represents only a small fraction, .1 percent, of the $271 billion in total real estate loans outstanding in federally insured credit unions, and does not represent a viable threat to the safety and soundness of the credit union industry.

<u>Mortgage-Backed Securities in Federally Insured Credit Unions</u>

Federally-insured credit union investments securitized by mortgage products represent 3.79 percent of federally insured credit union assets and 33.14 percent of federally insured credit union net worth. With the exception of an increase in 2007, mortgage-backed securities in relation to total assets have been declining since at least 2003.

Mortgage-Backed Securities - Percentage of Federally Insured Credit Union Assets					
Year End:	**Dec-03**	**Dec-04**	**Dec-05**	**Dec-06**	**Dec-07**
Mortgage Pass-Thru Securities[11]	2.59%	2.36%	1.96%	1.72%	1.79%
Collateralized Mortgage Obligations	2.08%	1.89%	1.52%	1.43%	1.94%
Commercial Mortgage Related Securities	N/A	0.07%	0.08%	0.05%	0.06%
Total Mortgage-Backed Securities	4.67%	4.32%	3.55%	3.21%	3.79%

As indicated by the following graph, federally insured credit union investments in mortgage-backed securities has generally declined over the last several years.



Mortgage-Backed Investments – Federally Insured Corporate Credit Unions

[11] A mortgage pass-through security consists of a set of marketable shares in a portfolio (pool) of real estate mortgages for which investors receive monthly payments of both interest and principal. Normally the package is secured by credit insurance so that investors are protected from the credit risks of the individual mortgages in the portfolio. However, no protection is provided against the cash flow and return volatility associated with unanticipated principal prepayments, which typically occur when interest rates drop and homeowners refinance their mortgages.

NCUA regulates and/or insures twenty-eight federally insured corporate credit unions.[12] These federally insured corporate credit unions are permitted to purchase and hold investments backed by mortgage products; however, by regulation these investments must be AAA or AA rated.[13] These higher rated investments assist in mitigating the risk of loss associated with the particular investment. Though these investments may include subprime loans, such loans are not predominant in the pool thereby mitigating risks which may impact investment value and performance.

The majority of mortgage-related securities held by natural person federal credit unions are either issued or guaranteed by government sponsored enterprises.[14] For natural person federal credit unions, the agency does not collect data on holdings insured by mono-line companies. Natural person federal credit unions may not invest in collateralized debt obligations (CDOs) to the extent CDOs are not mortgage-related securities.

To date, federal credit unions have not taken significant impairment charges for private label mortgage-backed securities. Similarly, the agency is aware of only isolated charges among state chartered, federally insured credit unions for permanent impairments of mortgage-backed securities or CDOs.

[12] A Corporate Credit Union is a credit union devoted to providing products and services to natural person credit unions which are in its field of membership.
[13] Investments rated as AAA or AA represent high credit-quality investment grade products.
[14] Investment regulations for state-chartered federally insured credit unions and state-chartered non-federally insured credit unions are set by each State.

Among federally insured corporate credit unions, the total exposure to securities insured by mono-line companies also is relatively small. Federally insured corporate credit unions are permitted to purchase only investment grade securities. Federally insured corporate credit unions hold small amounts of CDOs and have taken small impairment charges.

NCUA's corporate credit union supervision program closely monitors all investment security holdings. In response to decreased liquidity in the bond market, NCUA has increased the frequency of portfolio reviews at federally insured corporate credit unions.

NCUA's Demonstrated History of Mortgage Lending Guidance to the Industry

In the late 1970s, legislation expanded services to federally insured credit union members, to include mortgage lending. This added another option for consumers who found it difficult to obtain real estate loans from commercial banks and savings institutions. Over the last thirty years or so, mortgage lending in federally insured credit unions has been considered a relatively safe product, subject more to interest rate risk exposure than the credit risk typically associated with lending products. Typically, as emerging risks have been identified, NCUA has provided written guidance to federally insured credit unions, in the form of Letters to Credit Unions. Many of these pieces of guidance, some dating back to the 1970s, have been either cancelled or superseded by more relevant guidance to address emerging risks.

Letter to Credit Unions 124, dated June 1991, provides guidelines, most of which is still relevant in today's environment, for developing and maintaining an effective real estate lending portfolio; it addresses both the interest rate and credit risk associated with this type of lending. When written, the guidelines contained in this letter were not intended to curtail such lending but rather to clarify areas of risk and concern.

Recognizing the emergence of risk based lending efforts in the federally insured credit union industry, in 1995, NCUA issued Letter to Credit Unions 174 to all federally insured credit unions discussing the potential advantages and disadvantages to federally insured credit unions of risk based lending programs, or programs where subprime credit could be offered. Risk based lending involves setting a tiered pricing structure that assigns loan rates based upon an individual's credit risk. A tiered pricing structure enables federally insured credit unions to make more loans to disadvantaged, lower income, or credit-challenged individuals. Through a carefully planned risk-based lending program, federally insured credit unions can make loans to somewhat higher-risk borrowers, as well as better serve their lower-risk members.

Letter to Credit Unions 174 stated that "[c]redit unions should engage in risk-based lending, not as a means of re-pricing existing balance sheets, but as a tool to reach out to the underserved..." and also noted that "[s]afety and soundness should remain of paramount importance...." Attached to Letter to Credit Unions 174 was an informational whitepaper discussing safety and soundness considerations and stressing the importance of consumer compliance issues related to risk based lending. Specifically, the whitepaper discussed the necessity of planning, policies, procedures, portfolio limitations and monitoring, and effective pricing. Additionally, the whitepaper reminded federally insured credit unions of their obligations under the Equal Credit Opportunity Act, Fair Housing Act, and the Fair Credit Reporting Act. Finally, the whitepaper outlined the examination procedures NCUA would use to review these programs.

In 1999, NCUA issued Letter to Credit Unions 99-CU-05 to all federally insured credit unions restating that soundly managed risk based lending programs were a way to reach out to all members. In Letter to Credit Unions 99-CU-05, NCUA noted that those receiving the largest benefit from risk based lending programs would be individuals attempting to repair or establish credit, but reiterated the need for sound planning, underwriting, monitoring, and control. Additionally, Letter to Credit Unions 99-CU-05 noted that a federally insured credit union's capital adequacy would be evaluated considering the volume and type of risk based lending pursued and the adequacy of the credit union's risk management program. Lastly, Letter to Credit Unions 99-CU-05 provided credit unions with more information about NCUA's expectations for risk based lending program planning, loan policies, and procedures.

Over time, as the federally insured credit union industry evolved and demand for mortgage products increased, NCUA focused attention on the importance of proper balance sheet risk management for real estate loan products. In August of 1999, NCUA issued Letter to Credit Unions 99-CU-12 after identifying some interest rate risk given the changing balance sheet structure in a period when members where locking mortgage interest rates at the lowest point in thirty years. This letter and accompanying attached set of guidelines formally introduced such tools as GAP analysis, income simulation models, Net Economic Value, and other Asset Liability Management concepts.

NCUA revisited this important concept of proper interest rate risk management in the fall of 2003 when it issued Letter to Credit Unions 03-CU-15, titled Real Estate Concentrations and Interest Rate Risk Management for Credit Unions with Large Positions in Fixed-Rate Mortgage Products. This letter reemphasized the importance of properly monitoring and managing an increasing portfolio of fixed-rate mortgage products; at the time the industry was experiencing another record period of reduced interest rates coupled following several years of strong share growth.

Moving forward, NCUA identified a need to refocus the industry's attention to proper credit risk management of lending, including real estate lending, in the wake of alternative lending arrangements to increase lending opportunities. In September 2004, NCUA issued Letter to Credit Unions 04-CU-13, titled, Specialized Lending Activities to focus attention on three higher risk lending activities – subprime lending, indirect lending, and outsourced lending relationships. This letter highlighted some benefits of each of these arrangements while clearly outlining expectations that federally insured credit unions only engage in these activities after ensuring they have a system of internal controls to properly manage the unique risks involved.

As referenced in this Letter to Credit Unions, subprime lending involves higher levels of risk and requires greater skill to successfully implement. Properly managed, however, it can be a viable and safe component of a federally insured credit union's balance sheet. A well-managed subprime program enables federally insured credit unions to serve disadvantaged members. Sound underwriting practices, effective control and monitoring systems and sufficient capital levels are key components to a well-managed program.

Letter to Credit Unions 04-CU-13 outlined NCUA's underwriting expectations for federally insured credit unions engaged in subprime lending, noting the need to focus on borrowers' ability to repay loans as structured. A questionnaire on Subprime Lending Controls was also introduced to federally insured credit unions as an attachment to Letter to Credit Unions 04-CU-13. This questionnaire is available to examiners as part of the evaluation of risk based lending and subprime lending programs in federally insured credit unions with loan portfolios containing significant amounts of subprime loans.

In the spring of 2005, NCUA and the other banking agencies jointly issued guidance, titled Credit Risk Management Guidance for Home Equity Lending, to focus industry attention to an increasing concentration of Home Equity Lines of Credit (HELOCs) and close-end home equity loans. This guidance document offered up a credit risk management system supported by, among others, product development and marketing, origination and underwriting, third-party originations, collateral valuation management, and operations, servicing, and collections.

Later in 2005, after identifying precursor trends to the current mortgage environment and declining housing market, NCUA developed guidance for staff in the form of a Supervisory Letter on the increasing risks in mortgage lending. The letter focused on the evolution of products in the mortgage market, the unusual volume of originations of variable rate mortgage products in a low interest rate environment, and the market trend toward liberalization of underwriting standards. The alert outlined potential issues with "interest-only" and "payment-option" adjustable rate mortgages with illustrations of payment shock for each of the products discussed.

The above referenced Supervisory Letter was then issued to federally insured credit unions in October 2005 with Letter to Credit Unions 05-CU-15, which also addressed the use of alternative or exotic mortgage products to afford housing in areas of high housing value appreciation, as well as an apparent transition to a more liberalization of mortgage credit standards in general. Additionally, Letter to Credit Unions 05-CU-15 notified federally insured credit unions that "NCUA field staff will be monitoring these trends and will evaluate not only interest rate risk related to mortgage lending but also the increased credit risk associated with these newer mortgage products and more liberal underwriting standards."

In 2006, NCUA issued Nontraditional Mortgage Guidance and began work on Proposed Subprime Lending Guidance, both in tandem with other regulators. While nontraditional and subprime mortgage lending were not major components of federally insured credit union mortgage portfolios, NCUA was concerned that predatory and unsound lending in other areas of the marketplace may increase consumers' monthly debt burdens significantly, resulting in a "ripple effect" that would not only impact federally insured credit union members but also federally insured credit union asset quality. If federally insured credit union members begin to experience difficulty making payments on homes they have financed elsewhere, loan accounts at their federally insured credit unions could also be impacted.

As a result of comments received on the consumer protection section of the proposed Nontraditional Mortgage Guidance, the agencies crafted proposed illustrations of Consumer Information for Nontraditional Mortgage Products.[15] These illustrations are designed to assist consumers by providing examples of model or sample disclosures or other descriptive materials as part of the Interagency Nontraditional Mortgage Guidance.

Then, in April of 2007, NCUA and the other FFIEC[16] member agencies jointly released a statement encouraging financial institutions to work constructively with residential mortgage borrowers who may be unable to meet their contractual payment obligations.

[15] See 71 FR 58672.
[16] The Federal Financial Institutions Examination Council is made up of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the State Liaison Committee.

This joint statement explains that prudent workout arrangements consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower.

In July of 2007, NCUA and the other FFIEC member agencies jointly released a finalized Interagency Statement on Subprime Mortgage Lending[17] to address emerging risks and lending practices associated with certain subprime adjustable rate mortgage products that can cause payment shock to consumers. As with nontraditional mortgage products, although these types of loans do not appear to be prevalent in the federally insured credit union industry, the NCUA cautioned against the potential "ripple effect" to asset quality if some members have these types of loans at other financial institutions and are struggling to repay considerably higher priced mortgage payments. As with the Interagency Nontraditional Mortgage Guidance, the agencies issued proposed illustrations to assist financial institutions in implementing the guidance specifically related to the consumer protection section of the Interagency Statement on Subprime Mortgage Lending.

Last September, NCUA, the other FFIEC member agencies, and the Conference of State Bank Supervisors jointly issued a statement encouraging federally regulated financial institutions and state-supervised entities that service securitized residential mortgages to review and determined the full extent of their authority under pooling and servicing agreements to identify borrowers at risk of default and pursue appropriate loss

[17] The agencies published for comment the proposed Statement on Subprime Mortgage Lending on March 8, 2007. See 72 FR 10533.

mitigation strategies designed to preserve homeownership. Appropriate loss mitigation strategies may include, for example, loan modifications, conversions of an adjustable rate mortgage into a fixed rate mortgage, deferral of payments, or extending amortization. In addition, this issuance suggests institutions consider referring appropriate borrowers to qualified homeownership counseling services that may be able to work with all parties to avoid unnecessary foreclosures.

IV. CONCLUSION

The federally insured credit union system remains financially sound; they have effectively implemented guidance issued by NCUA related to real estate lending and have positioned the industry to weather this current economic downturn. While the data shows the industry is not entirely insulated from the adverse impact of the real estate lending crisis, it also supports the strong risk management principles effectively implemented by federally insured credit unions nationwide.

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Statement of

Donald L. Kohn

Vice Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

March 4, 2008

Chairman Dodd, Ranking Member Shelby and members of the Committee, it is my pleasure to appear today to discuss the condition of the U.S. banking system. In my remarks, I will summarize briefly the role of the Federal Reserve in banking supervision, provide an overall view of the health of the U.S. banking system, and then discuss some key areas of supervisory focus.

The U.S. banking system is facing some challenges, but remains in sound overall condition, having entered the period of recent financial turmoil with solid capital and strong earnings. The problems in the mortgage and housing markets have been highly unusual and clearly some banking organizations have failed to manage their exposures well and have suffered losses as a result. But in general these losses should not threaten their viability. We, along with the other banking agencies, have been working with banking organizations to identify and rectify those shortcomings in risk management and to ensure that the banking system continues to be safe and sound.

Role of the Federal Reserve in Banking Supervision

The Federal Reserve has supervisory and regulatory authority over a wide range of financial institutions and activities. It works with other federal and state supervisory authorities to ensure the safety and soundness of the banking industry, the stability of the financial system, and fair and equitable treatment of consumers in their financial transactions.

While the Federal Reserve is not the primary federal supervisor for the majority of commercial bank assets, it plays an important role as the "umbrella supervisor" of bank holding companies. The bank holding companies supervised by the Federal Reserve number approximately 5,000 and have consolidated assets of about $14.2 trillion. The Federal Reserve conducts inspections of all large, regional, and complex bank holding companies and maintains inspection teams on-site at the largest bank holding companies. For smaller less complex organizations, supervision is conducted through a combination of off-site monitoring and on-site inspections. These inspections, which are conducted using established procedures, manuals, and techniques, allow the Federal Reserve to review the organization's systems for identifying and managing risk across the organization and its various legal entities and to evaluate the overall financial strength of the organization. The primary purpose of these inspections is to ensure that the holding company and its nonbank subsidiaries do not pose a threat to the soundness of the company's depository institutions. In fulfilling this role, the Federal Reserve relies to the fullest extent possible on information and analysis provided by the appropriate supervisory authority of the company's bank, securities, or insurance subsidiaries.

The Federal Reserve is also the primary federal supervisor of state-member banks, sharing supervisory responsibilities with state supervisory agencies. In this role, Federal Reserve supervisory staff regularly conduct on-site examinations and off-site monitoring to ensure the soundness of supervised state member banks. There are over 870 state member banks whose assets total more than $1.5 trillion, representing about 12 percent of all commercial banks by number and about 14 percent of all commercial bank assets.

Consumer protection within the financial services industry is another important responsibility of the Federal Reserve. Among the Federal Reserve's responsibilities in this area are: writing and interpreting regulations to carry out many of the major consumer protection laws; reviewing bank compliance with regulations; investigating complaints from the public about compliance with consumer protection laws; and conducting community development activities.

Recent Performance of the U.S. Banking System

I would now like to address the condition of banking organizations supervised by the Federal Reserve. I will start by discussing bank holding companies, providing a brief overview of their recent performance, condition, and outlook. I will then do the same for state member banks.

Bank holding companies

Over the second half of 2007, bank holding companies (BHCs) experienced a substantial deterioration in asset quality and earnings, largely attributable to the effects of the slowing residential housing market on the quality of mortgage and construction loans. The sharp rise in subprime delinquencies, moreover, adversely affected the securitization market and placed strains on the liquidity and capital of some of the largest BHCs as these institutions brought off-balance sheet exposures onto their books. Many of these institutions also recognized significant valuation write-downs on assets affected by this market volatility.

The combination of sizable write-downs and substantially higher provisions for loan losses in response to deteriorating loan quality resulted in weaker profitability at BHCs in the third quarter of 2007 and overall losses of more than $8 billion in the fourth quarter based on preliminary regulatory report data. Nonperforming assets also increased notably as the quality of mortgages, home equity lines of credit, and loans to real estate developers weakened. However, despite these adverse developments, bank holding companies still reported total net income exceeding $90 billion for the full year of 2007. In addition, the overall nonperforming assets ratio remained below levels reached earlier in this decade.

The earnings performance of the fifty largest U.S. based bank holding companies as a group, which together represent more than three-fourths of all assets at bank holding companies, has clearly been subpar over the past two quarters and accounts for the industry's overall weak performance. In aggregate, these companies generated overall losses of over $9 billion for the fourth quarter, incorporating asset write-downs of more than $31 billion and loan loss provisions that exceeded loan charge-offs by $14 billion. Nonperforming assets also swelled at these companies during 2007, doubling from $33 to $67 billion, and raising the nonperforming assets ratio from a historically low 0.70 percent at December 31, 2006, to 1.25 percent at the end of 2007.

Liquidity has also been under pressure at some of the fifty largest bank holding companies. In many cases, these pressures reflect difficulties securitizing some assets and the need to bring on balance sheet some assets that had previously been securitized. As a result, banking companies have experienced a moderate overall decline in liquid assets as a portion of total assets, and strains have emerged in term interbank funding markets. Bank holding companies are actively responding to these pressures and some have sought to increase more stable sources of funding to bolster their liquidity positions. In addition, as noted in last week's *Monetary Policy Report*, the Federal Reserve has taken a number of steps to address the difficulties in term funding markets.

Asset write-downs and unplanned increases in assets have placed pressure on capital ratios and caused some banking organizations to take a more cautious approach to extending credit. However, large bank holding companies in aggregate and individually continued to maintain regulatory capital ratios in excess of minimum regulatory requirements. As of December 31, 2007, the fifty largest bank holding companies reported aggregate tier 1 leverage, tier 1 risk-based, and total risk-based capital ratios of 5.3, 7.5, and 11.1 percent, respectively. In part, these capital ratios reflect steps taken by several large BHCs to replenish depleted equity positions by curtailing share repurchases, reducing dividends, and raising additional capital in order to maintain desired capital levels relative to regulatory norms. Indeed, in recent months, large bank holding companies have raised more than $50 billion in capital.

Looking ahead, bank holding companies will continue to face challenging market conditions and persistent pressure on earnings. More asset write-downs are likely as the market continues to adjust risk premiums and valuations change. Adverse trends in loan quality will almost certainly continue and will require close monitoring by banking institutions and supervisory agencies alike. Liquidity positions will need to continue to be actively managed and banking organizations will need to implement risk management improvements to remedy the deficiencies that have been noted by companies and supervisors over the past year.

State member banks

Most state member banks entered the recent financial disturbance in sound condition, reporting strong earnings through the first half of 2007 and maintaining high capital ratios. As of December 31, 2007, more than 99 percent of these banks reported risk-based capital ratios consistent with a "well-capitalized" designation under Prompt Corrective Action standards. However, profitability suffered in the second half of 2007 as state member banks increased loan loss provisions, reducing the aggregate return on average assets from 1.4 percent for the full year 2006 to 1.1 percent for 2007. In addition, although still below the most recent peak in 2002, the nonperforming assets ratio moved up sharply over the past year. In large part, this increase reflected deterioration in residential mortgages and loans to builders and has contributed to an increase in the portion of state member banks with less-than-satisfactory supervisory ratings from 4.5 percent at year-end 2006 to 6.3 percent at the end of 2007. Indeed, half of the state member banks that were downgraded to less-than-satisfactory CAMELS ratings since mid-2007 have evidenced significant financial or risk management weaknesses related to commercial real estate lending activities.

State member banks entered 2007 relatively well-positioned to confront and withstand more adverse conditions. However, like bank holding companies, these banks face deteriorating credit conditions in 2008 and we anticipate further increases in their loan delinquencies and charge-offs. We also foresee more difficult liquidity conditions for some of these banks, and we expect to see the number with less than satisfactory CAMELS ratings of 3, 4, or 5 grow from the low level that has prevailed over the last several years.

Key Areas of Supervisory Focus

As the nation's central bank, the Federal Reserve is acutely aware of conditions in the economy and financial markets and the challenges those conditions pose to the safety and soundness of banking organizations. Accordingly, we have been focusing supervisory efforts on those institutions most exposed to residential and commercial real estate or other sectors that have come under pressure. We are also attentive to those institutions that would suffer most from a prolonged period of deterioration in economic conditions. We continue to focus our examinations on the financial condition of banking organizations--including the adequacy of their liquidity, capital, and loan loss reserves and their consequent ability to recognize additional losses. We are also evaluating risk management practices very closely, including scrutinizing governance and controls, given some of the risk management lapses in those areas revealed by recent events.

At this point, I would like to provide a summary of the key areas of supervisory focus, including residential mortgage lending, consumer protection, bank liquidity and capital positions, consumer (nonmortgage) lending, commercial real estate, and commercial lending.

Residential mortgages

Among the challenges currently facing the U.S. banking system, residential mortgage lending has presented the largest problems so far. In addition to the economic and social distress created for many homeowners and communities, the sharp increases in subprime mortgage loan delinquencies and foreclosures over the past year have affected the banking industry significantly.

Delinquency rates on subprime adjustable-rate mortgages (ARMs) began to increase in 2006, and by December 2007, more than one-fifth of these loans were seriously delinquent (that is, ninety days or more delinquent or in foreclosure). For subprime mortgages with fixed interest rates, delinquency rates have moved up significantly in recent months, to the upper end of their historical range. For prime and near-prime mortgages, performance weakened somewhat in 2007, but generally remained fairly solid. The continued erosion in the quality of mortgage credit has led to an increase in initial foreclosure filings, with foreclosures rising the most in areas where home prices have fallen after an earlier period of rapid increase.

Some banking organizations in particular have been adversely affected by problems with residential mortgages. A number of large organizations have suffered substantial write-downs on subprime mortgages. The effect of the problems in subprime mortgages, however, extends beyond the mortgage accounts themselves. Securities backed in part or full by subprime assets have also declined in value as investors factored in estimates of potential losses. Where the securities had been heavily structured or leveraged, these losses have in some cases been severe. Further, many banks financed nonbank firms that originated these assets through "mortgage warehouse" lines of credit or through repurchase agreements. As the banks saw the values of the financed mortgages falling last year, their margin calls put a number of originators out of business.

Most recently, home equity lending has emerged as a more challenging area. As banking organizations report increased delinquencies and losses in home equity lines of credit (HELOCs), especially in light of falling housing prices in some markets, we continue to monitor current and potential exposures, and are reviewing the industry's collateral valuation methods.

Federal Reserve supervisors have focused very intensely on problems with residential mortgages and are taking appropriate action. In reaction to the immediate problems facing homeowners struggling to meet payment obligations, the Federal Reserve and other banking agencies have encouraged mortgage lenders and mortgage servicers to pursue prudent loan workouts through such measures as modification of loans, deferral of payments, extension of loan maturities, capitalization of delinquent amounts, and conversion of ARMs into fixed-rate mortgages or fully indexed, fully amortizing ARMs. The Federal Reserve has also collaborated with community groups to help homeowners avoid foreclosure.

In addition, the Federal Reserve has taken steps aimed at avoiding future problems in subprime mortgage markets while still preserving responsible subprime lending and sustainable homeownership. Through examinations and other supervisory activities, we are taking our knowledge of the root causes of bank-related mortgage lending problems and using it to work with institutions to improve risk management practices in this area. Some of this work builds on the guidance on subprime mortgages issued last summer by the U.S. banking agencies. The guidance is designed to help ensure that borrowers obtain adjustable-rate mortgages that they can afford to repay and can refinance without prepayment penalty for a reasonable period before the first interest rate reset. The Federal Reserve, along with the other banking agencies, issued similar guidance on nontraditional mortgages in 2006.

Given significant growth in banks' HELOC portfolios over the past several years, the agencies have been concerned for some time that banks' HELOC underwriting placed insufficient emphasis on the creditworthiness of borrowers and placed too much weight on the value of the collateral during a booming housing market. In 2005, the agencies issued joint guidance that outlined these concerns and set forth supervisory expectations for risk management of home equity lending activities. The guidance emphasized the importance of active portfolio management, particularly for those institutions pursuing significant growth in HELOC balances and underwriting HELOCs with high loan-to-value limits and limited documentation on borrowers' asset and income.

Consumer protection

As the Committee is aware, problems associated with residential mortgages stem in part from lax lending standards. In some cases, improper practices vis-à-vis consumers contributed to the defaults we have seen in the subprime mortgage market. To address these practices, under the authority given to it by the Congress, the Federal Reserve has taken action to protect consumers in their mortgage transactions. In December, the Board issued for public comment a comprehensive set of new regulations to prohibit unfair or deceptive practices in the mortgage market, under the authority granted us by the Home Ownership and Equity Protection Act of 1994 (HOEPA). The proposed rules would apply to all mortgage lenders and would establish lending standards to help ensure that consumers who seek mortgage credit receive loans whose terms are clearly disclosed and that can reasonably be expected to be repaid. Accordingly, the rules would prohibit lenders from engaging in a pattern or practice of making higher-priced mortgage loans without due regard to consumers' ability to make the scheduled payments. In addition, for all mortgage loans, our proposal addresses misleading and deceptive advertising practices, requires borrowers and brokers to agree in advance on the maximum fee that the broker may receive, bans certain practices by loan servicers that harm borrowers, and prohibits coercion of appraisers by lenders. We expect substantial public comment on our proposal, and we will carefully consider all information and viewpoints while moving expeditiously to adopt final rules.

The effectiveness of the new regulations, however, will depend critically on strong enforcement. To that end, in conjunction with other federal and state agencies, we are conducting compliance reviews of a range of mortgage lenders, including nondepository lenders. The agencies will collaborate in determining the lessons learned and in seeking ways to better cooperate in ensuring effective and consistent examinations and improved enforcement of all categories of mortgage lenders.

We are also working toward finalizing rules under the Truth in Lending Act that will require new, more informative, and consumer-tested disclosures by credit card issuers. Separately, we are actively reviewing potentially unfair and deceptive practices by issuers of credit cards. Using the Board's authority under the Federal Trade Commission Act, we expect to issue proposed rules regarding these practices this spring.

Liquidity and capital issues

As noted earlier, liquidity disruptions in certain financial markets have created challenges for banking organizations. During times of systemwide stress, such as the one we are currently experiencing, significant liquidity demands can emanate from both the asset and the liability side of a bank's balance sheet. For example, we have recently seen how unanticipated draws on liquidity facilities by structured investment vehicles, commercial paper conduits, and others can lead to significant growth in bank assets. Moreover, some organizations have also encountered difficulty in selling whole loans or securitizing assets as planned. There were also cases in which reputational concerns have prompted banks or their affiliates to provide liquidity support to a vehicle or to incorporate some of the vehicle's assets onto the bank's balance sheet, even when the bank had no legal obligation to do so. In a few cases, these unexpected increases in the balance sheet created some pressures on capital ratios, even when capital levels remained unchanged. Further instances of unplanned asset expansion could continue.

Reduced liquidity in the markets for certain structured credit products continue to create valuation challenges and concerns about these products have spread to other sectors. Illiquidity in some credit markets may make it difficult for some market participants, including banking organizations, to hedge positions effectively.

From a supervisory perspective, it has become clear that some bankers did not adequately explore scenarios in which market liquidity could be disrupted, or in which there could be sudden demands for the institution's own liquidity. We are working very closely with banking organizations to ensure that they improve liquidity risk management practices, including contingency funding plans and improved information systems, and ensure that these practices are integrated with other aspects of risk management. Banking organizations must employ more comprehensive stress testing and scenario analysis--exercises that capture both bank-specific problems and broader market disruptions--to assess the impact that problems in market liquidity, as well as funding liquidity, can have on capital adequacy.

Credit cards and other consumer lending

Of course the Federal Reserve is focused on the possibility that troubles in the residential mortgage sector could adversely affect other types of consumer lending, such as credit cards or auto loans. Banking organizations' consumer loans excluding mortgages--which include credit cards and auto loans--grew somewhat faster in 2007 than in 2006, suggesting some substitution of nonmortgage credit for mortgage credit. The pickup in consumer debt was mostly attributable to faster growth in revolving credit, a pattern consistent with the results of the Federal Reserve's Senior Loan Officer Opinion Survey. Banks, on net, reported easing lending standards on credit cards over the first half of 2007 and reported little change in those standards on net over the second half of the year. In contrast, significant portions of respondents in the second half of 2007 reported that they had tightened standards and terms on other consumer loans, a change that may have contributed to a slowing in the growth of nonrevolving loans over the final months of 2007.

Thus far, the quality of other consumer loans has remained satisfactory. However, the delinquency rates on credit cards and consumer installment loans at banking organizations increased over the second half of the year. Moreover, although household bankruptcy filings remained below the levels seen before the changes in bankruptcy law implemented in late 2005, the bankruptcy rate rose modestly over the first nine months of 2007 and could be a harbinger of increasing delinquency rates on other consumer loans. In view of this risk, Federal Reserve supervisors are monitoring these consumer loan segments for signs of spillover from residential mortgage problems, particularly in regions showing homeowner distress, and are paying particular attention to the securitization market for credit card loans.

Commercial real estate

Commercial real estate is another area that requires close supervisory attention. The delinquency rate on commercial mortgages held by banking organizations almost doubled over the course of 2007 to over two percent. The loan performance problems were the most striking for construction and land development loans--especially for those that finance residential development--but some increase in delinquency rates was also apparent for loans backed by nonfarm, nonresidential properties and multifamily properties.

In the most recent Senior Loan Officer Opinion Survey, a number of banking organizations reported having tightened standards and terms on commercial real estate (CRE) loans. Among the most common reasons cited by those that tightened credit conditions were a less favorable or more uncertain economic outlook, a worsening of CRE market conditions in the areas where the banks operate, and a reduced tolerance for risk. Notably, a number of small and medium-sized institutions continue to have sizable exposure to CRE, with some having CRE concentrations equal to several multiples of their capital.

Despite the generally satisfactory performance of commercial mortgages in securitized pools, spreads of yields on BBB-rated commercial mortgage-backed securities over comparable-maturity swap rates soared, and spreads on AAA-rated tranches of those securities have risen to unprecedented levels. The widening of spreads reportedly reflected heightened concerns regarding the underwriting standards for commercial mortgages over the past few years, but it also may be the result of increased investor wariness regarding structured finance products. CRE borrowers that require refinancing in 2008, particularly those with short-term mezzanine loans, will face difficulty in locating new financing under tighter underwriting standards and reduced demand for CRE securitizations.

In those geographic regions exhibiting particular signs of weakness in real estate markets, for several years we have been focusing our reviews of state member banks and bank holding companies on evaluating growing concentrations in CRE. Building on this experience, we took a leadership role in the development of interagency guidance addressing CRE concentrations, which was issued in 2006. More recently, because weaker housing markets have clearly started to adversely affect the quality of CRE loans at the banking organizations that we supervise, we have heightened our supervisory efforts in this segment even more. These efforts include monitoring carefully the impact that lower valuations could have on CRE exposures, as well as evaluating the implementation of the interagency guidance on concentrations in CRE, particularly at those institutions with exceptionally high CRE concentrations or with riskier portfolios.

Recently, we surveyed our examiners about their assessments of real estate lending practices at a group of state member banks with high concentrations in CRE lending. We had two main objectives for this effort. First, we wanted to evaluate the Federal Reserve's implementation of the interagency CRE lending guidance and to determine whether there were any areas in which additional clarification of the guidance would be helpful to our examiners. Second, we wanted to assess the degree to which banks were complying with the guidance and gain further information on the degree of deterioration in real estate lending conditions. Through this effort, we confirmed that many banks have taken prudent steps to manage their CRE concentrations, such as considering their exposures in their capital planning efforts and conducting stress tests of their portfolios. Others, however, have not been as effective in their efforts and we have uncovered cases in which interest reserves and extensions of maturities were used to mask problem credits, appraisals had not been updated despite substantial recent changes in local real estate values, and analysis of guarantor support for real estate transactions was inadequate. Based on these findings, we are currently planning a further series of targeted reviews to identify those banks most at risk to further weakening in real estate market conditions and to promptly require remedial actions. We have also developed and started to deliver targeted examiner training so that our supervisory staff is equipped to deal with more serious CRE problems at banking organizations as they arise.

Commercial and industrial loans

While there are some pockets of poor performance in commercial and industrial lending, for the most part the sector continues to perform fairly well. Commercial and industrial (C&I) loans surged in 2007 because of extremely rapid growth in the second half of the year resulting, in part, from large banks' inability to syndicate leveraged loans that they had underwritten. Finally, after the issuance of an unprecedented amount of leveraged syndicated loans over the first half of 2007, issuance declined considerably in the second half of the year, when demand by nonbank investors for those loans diminished.

In the Senior Loan Officer Opinion Survey of October 2007 and January 2008, many banks reported charging wider spreads on C&I loans--the loan rate less the bank's cost of funds--representing the first such tightening in several years. A large proportion of banks also indicated that they had tightened lending standards. Most of the banks that tightened terms and standards indicated that they had done so in response to a less favorable or more uncertain economic outlook and a reduced tolerance for risk. However, about one-fourth of the banks cited concerns about their own liquidity or capital position as reasons for tightening.

The delinquency rate on C&I loans at commercial banks trended higher throughout 2007, but remained near the bottom of its historical range at the end of the year. Charge-offs on C&I

loans at commercial banks also increased in 2007, particularly in the fourth quarter when the charge-off rate moved up from 0.48 to 0.85 percent of average C&I loans. In addition, examiners continue to note early signs of credit deterioration at some banks where delinquencies have not yet increased significantly.

Here, too, supervisors are responding to ensure that banks' commercial and industrial (C&I) lending activities remain safe and sound. Examiners are focusing on underwriting standards, evaluating both the methodology and results of banks' stress tests of credit portfolios and the impact of potential shocks on credit and asset quality. Credit administration--that is, banks' activities to monitor their loans and maintain their credit operations--are also being watched carefully. Examiners are looking for signs of imprudent renewals, excessive waivers of terms without compensation, or other activities which might mask recognition of poorly performing credits. We are emphasizing that banks employ appropriate internal controls that will ensure that borrowers meet their obligations under credit agreements--not only obligations for payments, but also obligations to furnish up-to-date information such as financial statements--which allow the bank to properly assess credit risk. We also continue to regularly review internal bank reports and meet with bank management to discuss underwriting and credit performance in order to identify problem areas early and while they are still manageable.

Supervisory Strategies for Going Forward

The U.S. banking industry is facing serious challenges; the Federal Reserve, working with the other U.S. banking agencies has acted--and will continue to act--to ensure that the banking system continues to be safe and sound and able to meet the credit needs of a growing economy. Our initial assessment of the weaknesses at individual firms indicates that risk management systems and senior management oversight at some institutions were not sufficiently robust. As supervisors, we must redouble our efforts to ensure risk management practices and controls keep pace with changes in financial markets and business models, providing both positive incentives and clear consequences.

Supervisors have emphasized for several years the concept of enterprise-wide risk management. However, problems stemming from recent events indicate that bank management in many cases was not fully aware of the latent risks contained in various structures and financial instruments, and how those risks could manifest themselves. Supervisors, therefore, will be enhancing their focus on the capacity of a firm as a whole to manage risk and to integrate risk assessments into the overall decision-making by senior management. Additional emphasis on enhancing stress-testing is also appropriate to focus more bank attention on risks that have a low probability of occurrence but unacceptably high potential costs. As part of an international effort, we have also been developing a set of preliminary "lessons learned" from banking organizations' experiences with recent market events, containing examples of both stronger and weaker practices, to share with the banking industry as well as our own examination staff.

Finally, as part of a responsible and proactive supervisory approach, and as we have done in the past, we are conducting critical assessments of our own supervisory programs, policies, and practices. This is a prudent step and is consistent with long-standing Federal Reserve practice. In the same vein as the "lessons learned" analysis for banking institutions mentioned above, our intent is to identify opportunities for improving our own supervisory processes both within the current environment and as preparation for future supervisory challenges. These assessments will be specific to our supervisory programs as well as their execution over the past several years, will be conducted across a broad portfolio of institutions and supervisory programs, and should help to further strengthen our supervisory objectives and procedures.

It will take some time for the banking industry to work through this current set of challenges and for financial markets to recover from recent strains. The Federal Reserve will continue to work with other U.S. banking agencies and the Congress to help ensure that bank safety and soundness is maintained.

TESTIMONY OF

THOMAS B. GRONSTAL

IOWA SUPERINTENDENT OF BANKING

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

"THE CONDITION OF THE BANKING INDUSTRY"

Before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

March 4, 2008, 10:00 a.m.

Room 538, Dirksen Senate Office Building

Introduction

Good morning Chairman Dodd, Ranking Member Shelby, and other distinguished members of the Committee. My name is Thomas B. Gronstal, and I am the Superintendent of Banking for the state of Iowa. I am pleased to testify today on behalf of the Conference of State Bank Supervisors (CSBS).

CSBS is the professional association of state officials responsible for chartering, supervising, and regulating the nation's over 6,000 state-chartered commercial and savings banks. For more than a century, CSBS has given state supervisors a national forum to coordinate supervision of their regulated entities, to develop regulatory policy, to provide training to state officials, and to represent state officials before Congress and the federal financial regulatory agencies.

In addition to regulating banks, most state banking departments also supervise the residential mortgage industry. In the past few years, CSBS has expanded its mission beyond traditional commercial bank supervision and has been working closely with the American Association of Residential Mortgage Regulators (AARMR)[1] to enhance state supervision of the mortgage industry. All 50 states and the District of Columbia provide regulatory oversight of the residential mortgage industry. Under state jurisdiction are more than 85,000 mortgage companies with 68,000 branches and over 407,000 loan officers and other professionals.[2]

Thank you for the opportunity to discuss the state of the nation's banking industry today, and specifically the challenges and conditions facing the state banking system.

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[1] AARMR is the organization of state officials responsible for the administration and regulation of residential mortgage lending, servicing, and brokering.

[2] The above numbers do not include the state of California's Department of Real Estate's approximately 480,000 licensed real estate agents who could also function as a mortgage broker under their license.

Emerging Trends

Overall Condition of the Banking Industry

The problems we are currently experiencing in the banking industry—reduced earnings, tight liquidity, increased charge-offs—were triggered by the weakening of the housing market and the ensuing credit crunch. Problems in the housing market and with residential mortgage lending are well known. I will discuss state efforts to enhance supervision of the residential mortgage industry later in my testimony. First, however, I want to address some other emerging issues that my fellow state regulators identified in a recent CSBS survey.

Overall, state supervisors are witnessing a general decline in the condition of state chartered banks. With only a few exceptions, these declines are gradual. The areas witnessing a more rapid decline appear to be more pronounced in those areas with more fundamental economic problems. Naturally, the driver of the decline in conditions is related to credit. However, about a third of my colleagues are beginning to see these credit issues impact liquidity. This is a direct result of uncertainty surrounding the valuation of collateral and the lack of market confidence in portions of the financial sector which are spilling over to other sectors.

While state regulators are preparing to handle a greater number of bank failures than we have had to in the last several years, based on current information and conditions, we do not expect widespread failures. However, while a manageable number of bank failures have a limited impact on the national economy, from our localized perspective any bank failure is very disruptive to the economy and consumers in our communities and states. Additionally, over 80% of my colleagues see an increase in merger activity related to overall banking conditions. While not without challenges, mergers are a more desirable and orderly method of dealing with problem institutions.

Capital Markets and the Impact on Community Banks

While we work through the many issues related to residential mortgage lending, it is critical for us to consider emerging risks as a result of contagion or other weakness. Current capital market conditions have seriously limited the ability of community banks to issue trust preferred securities and other debt type instruments. While the capital needs of community banks are considerably different than the well-publicized capital injections sought by large, internationally active banks, they are necessary to grow, expand product offerings, and seize merger opportunities. Much attention has been paid to the largest institutions as they have faced a capital crunch. The impact of this capital crunch on the community banking sector must not be overshadowed by the problems of the money center banks, as community banks have proven to be a great source of strength and stability for communities and economies across the country.

Bond Portfolio

The most immediate housing related risks for most state chartered banks have appeared in the banks' bond portfolios. As has been widely reported, many of these securities were creatively structured, questionably rated, and lacked a tremendous amount of transparency. This situation presents serious issues which Wall Street, the ratings agencies, and the regulators must address. However, we hold bank management responsible for the investments they make and the required due diligence. In this regard, we applaud the FDIC's pursuit of a "back to basics" approach to examiner training, expectations of bank management and supervision. While much has changed in banking since the last significant downturn in banking, many of the fundamentals of bank safety and soundness supervision continue to be very relevant to the industry and examiners.

Commercial Real Estate

Weakness in the commercial real estate sector is emerging in certain areas of the country. This is a cyclical change in the market following a period of tremendous growth. Concern over concentrations of commercial real estate loans have been expressed by the bank regulators for the last several years. This is a situation which will demand significant regulatory resources as the market adjusts.

Student Loans

Investors' lack of confidence in bond ratings, bond insurers and collateral valuation of asset backed securities has led to failures in the auction rate certificate market. One of the primary sources for funding of secondary markets for federally guaranteed and private student loans is the auction rate certificate market. The current lack of investor interest in these markets will curtail funding of student loans this year. In my state the primary secondary market for student loans, Iowa Student Loan Liquidity Corporation (ISL) is a non-profit corporation which buys and services student loans from banks, thrifts and credit unions. ISL is working with financial institutions to solve this funding problem, but it will be challenging to replace the auction rate certificate funding.

Agricultural Sector

My fellow state supervisors and I are closely watching the agricultural sector. Current agricultural conditions are reminiscent of conditions experienced in the 1970s, which led to the economic and financial collapse of the 1980s. Currently, we are witnessing a combination of high oil and high commodity prices. The value of farm land is directly correlated to the prices of commodities grown on it. The dramatic increase of farmland value in the last few years makes the agricultural sector look strong. In the future, should the price of corn, soybeans, and other commodities decrease, the price of farm land would most likely also fall. If there has been too much leveraged or loaned against the inflated value of farm land, the bubble will burst and we will once again experience an economic crisis similar to that of the 1980s. The continuing disappearance of manufacturing jobs from the rural mid-west will make it harder to recover from a future agricultural slump.

Reverse Mortgages

Many of my colleagues have expressed concerns regarding the marketing push and growing popularity of reverse mortgages. These products can be very beneficial for some borrowers, but they are ripe for consumer abuse and fraud and could present some significant long-term accounting and valuation issues. CSBS has developed a one-day seminar designed to help state mortgage examiners learn about the fast-developing reverse mortgage market. It will feature a practical industry perspective including hands-on exercises and presentations from the Department of Housing and Urban Development (HUD), the Office of Thrift Supervision (OTS) and state regulators. A case study will help participants learn how to examine a reverse mortgage loan file. This program is designed for all levels of state mortgage regulators and examiners from those responsible for developing and implementing regulations and policies to those performing examinations of reverse mortgage originators and lenders.

Reevaluation of Basel II in a Crisis

As state and federal regulators work together to deal with problems in credit markets and evaluate emerging risks, we are very fortunate to enter this cycle following a period of record earnings and strong capital ratios. As a part of our current policy deliberations, we must take stock of our current capital framework and the direction we are headed with the implementation of the advanced approaches of Basel II. With significant questions being raised about the models utilized by the ratings agencies and concerns regarding the transparency of institutions which utilize Structured Investment Vehicles (SIVs), state supervisors believe it is critical to evaluate Basel II in the context of the current crisis. We need to be confident the banking industry will be as strong going into the next crisis after operating under the Basel II framework and that there will be sufficient transparency in our largest institutions to make this assessment.

Testing Supervision and Bank Management in an Economic Downturn

We have been extremely fortunate to have experienced a very long and broad period of growth and record earnings in the banking industry. However, one of the consequences is that a generation of bankers and examiners has been untested in a stressed economy. While there is no teacher like experience, during this current environment of deteriorating conditions in financial institutions, this lack of experience needs to be addressed by both regulators and financial institutions with appropriate oversight from more experienced management.

Market cycles are inevitable. Regulators do their best to identify emerging risks and weakness in our financial system. As a result, the risk management practices and tools of the industry continue to evolve. However, as our systems of regulations and supervisory methods evolve we need to step back and examine whether they continue to provide clear rules and expectations for the industry and regulators, and transparency for investors. These principles have traditionally been the hallmark of our banking system. For this reason I would reiterate my concerns about the direction of bank supervision and determinations of capital adequacy that rely heavily on assumption driven modeling. While financial models can be a helpful tool in measuring and identifying risk they must do so in ways that are understandable to bank management and examiners. And they cannot replace the experienced human judgment of a banker or a regulator.

The Residential Mortgage Market

The decline of the housing market and the resulting roiling of the capital markets have been well-publicized and documented. The causes of the crisis we are experiencing result from the foundations of our financial system, not just our mortgage origination system, and all regulators must reflect on how we can collaborate to address the weaknesses of our system that this crisis has exposed.

State and federal financial regulators have developed—and continue to develop—guidelines, best practices, and regulations to prevent abusive lending practices in the mortgage industry. Congress and state legislatures have passed or are debating legislative initiatives designed to change industry standards and protect consumers. An array of market participants—regulators, attorneys general, and servicers, among them—are engaged in loan modification strategies to help homeowners avoid foreclosure.

CSBS contends that an enhanced regulatory regime for the residential mortgage industry is absolutely necessary to ensure legitimate lending practices, provide adequate consumer protections, and to once again instill both consumer and investor confidence in the housing market. The vast majority of mortgage bankers, brokers, and lenders are honest, law-abiding mortgage providers. And many of the problems we are experiencing are not the result of "bad actors" but rather bad assumptions by the architects of our modern mortgage finance system. Enhanced supervision and industry practices can successfully weed out both the bad actors and address the bad assumptions. If regulators and the industry don't address both causes we will only have the veneer of reform and we risk repeating our mistakes.

One lesson we should learn from this crisis is that nationalization of supervision and applicable law is not the answer. For those who were listening, the states provided plenty of warning signs of the problems to come. The flurry of state predatory lending laws and laws to create new regulatory structures for lenders and mortgage brokers that banks and the capital markets were funding were indicators that things were not right in our mortgage lending industry. To respond to this lesson by eliminating the early warning signs that the states provide seems ironic. It is in effect, providing regulatory relief to those that created the problem. Just as checks and balances are a vital part of our democratic government, they serve an equally important role in our financial regulatory structure. The United States boasts one of the most powerful and dynamic economies in the world because of those checks and balances, not despite them.

Most importantly, it serves the consumer interest that the states continue to have a role in financial regulation. While CSBS recognizes that the mortgage market is a nationwide industry that has international implications ultimately, local economies and individual homeowners are most affected by mortgage market fluctuations. State regulators must remain active participants in mortgage supervision because of our knowledge of local economies, and our ability to react quickly and decisively to protect consumers. To that end, the states, through CSBS and ARMR, are working to improve mortgage supervision through enhanced cooperation and coordination with one another and our federal regulatory counterparts.

This Committee held a hearing one year ago on turmoil in the mortgage market. North Carolina Commissioner of Banks Joe Smith testified on behalf of CSBS during that hearing and reported on the initiatives state regulators had developed to protect consumers and improve market practices. I would like to provide you with an update on the progression of these initiatives over the past year.

State Initiatives to Improve Supervision of the Residential Mortgage Industry

CSBS-AARMR Nationwide Mortgage Licensing System (NMLS)

Last year, Commissioner Smith told you of our plan to launch a nationwide licensing system to improve the efficiency and effectiveness of the U.S. mortgage market, to enhance consumer protection, to fight mortgage fraud and predatory lending, to increase accountability among mortgage professionals, and to unify and streamline state license processes for mortgage lenders and brokers.

I am pleased to report that the CSBS-AARMR Nationwide Mortgage Licensing System (NMLS) went live, as scheduled, on January 2, 2008. This system is more than a database. It serves as the foundation of modern mortgage regulation by providing transparency for regulators, the industry, investors, and consumers. Seven inaugural participating states, including my home state of Iowa, started using the system on January 2. Eight additional state agencies will being using the System in July 2008, and four to six state agencies will join the NMLS on a quarterly basis through 2009. To date, 42 state agencies representing mortgage regulators in 40 states have signed the Statement of Intent, indicating their commitment to participate in the NMLS. Eventually, we expect all 50 states to transition onto the System. I have attached, as Exhibit A, a map which indicates when states will begin using the NMLS.

In the first two months of operation, NMLS:

- Is currently managing over 1,600 company mortgage licenses;
- Is currently managing over 800 branch licenses; and
- Is currently managing over 2,000 loan officer licenses.

The NMLS will change the world of mortgage supervision. The System creates a single record for every state-licensed mortgage company, branch, and individual that is shared by all participating states. This single record allows companies and individuals to be tracked across state lines and over any period of time. Additionally, consumers and the industry will eventually be able to check on the license status and history of the companies and individuals with which they wish to do business.

The NMLS provides profound benefits to consumers, state supervisory agencies, and the mortgage industry. Consumers will have access to a central repository of licensing and publicly adjudicated enforcement actions. Each state regulatory agency will retain its authority to license and supervise, but the NMLS eliminates unnecessary duplication and implements consistent standards and requirements across state lines. Honest mortgage bankers and brokers will benefit from the removal of fraudulent and incompetent operators, and from having one central point of contact for submitting and updating license applications.

The NMLS also provides the regulatory foundation contained in the comprehensive mortgage reform legislation, H.R. 3915, passed by the House and in S. 2595, the "Secure and Fair Enforcement for Mortgage Licensing Act of 2008," recently introduced by Senators Feinstein and Martinez.

Pilot Programs with Federal Regulatory Agencies

Late in 2007, CSBS, the Federal Reserve, the OTS, and the Federal Trade Commission (FTC) engaged in a pilot program. Under this program, state examiners will join examiners from the Fed, OTS, and FTC to conduct simultaneous examinations of mortgage companies whose separate charters cross federal and state jurisdiction. We applaud the Federal Reserve, and Governor Kroszner in particular, for their leadership on this program. This pilot is truly the model for coordinated state-federal supervision.

Uniform Standards for Testing and Education

Also during last year's hearing, Commissioner Smith introduced the development of education and testing requirements for mortgage professionals. CSBS and AARMR are spearheading a regulatory/industry cooperative project called the Mortgage Industry Nationwide Uniform Testing and Education Standards (MINUTES). The project involves regulatory representatives from five states (Louisiana, North Carolina, Oregon, Pennsylvania, and South Carolina) cooperating on a task force with representatives from three mortgage industry associations (MBA, AFSA and NAPMW).

The initiative, begun in early 2007, provides model language establishing uniform standards for mortgage professional testing and education, and streamlines the process for licensees to comply with these standards. MINUTES will ensure that licensed mortgage providers and their loan originators are held to the same standards and expectations, regardless of the state in which they make loans. Once implemented, MINUTES will provide an Internet portal connecting state approved educators with mortgage professionals and then connecting testing and education satisfaction with the Nationwide Mortgage Licensing System for a seamless interface of licensing and continuing education requirements. Users of the NMLS will be able to identify mortgage professionals who have successfully passed a test and are current on their education requirements for each state in which they are licensed to conduct business.

CSBS-AARMR Guidance on Nontraditional Mortgage Product Risks

In October 2006, the federal financial agencies issued the *Interagency Guidance on Nontraditional Mortgage Product Risks* which applies to all banks and their subsidiaries, bank holding companies and their non-bank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions. Recognizing that the interagency guidance did not apply to those mortgage providers not affiliated with a bank holding company or an insured financial institution, CSBS and AARMR developed parallel guidance.

CSBS and AARMR issued parallel guidance in November 2006 to apply to state-supervised residential mortgage brokers and lenders. Over the past year, we have continued to encourage state agencies to adopt the guidance in some form. As of today, March 4, 2008, 44 states plus the District of Columbia have adopted the guidelines developed by CSBS and AARMR. Ultimately, we expect all 50 states to adopt the guidance.[3]

[3] To track state adoption of the CSBS-AARMR *Guidance on Nontraditional Mortgage Product Risks*, go to http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/NTM_State_Implement.htm.

CSBS-AARMR-NACCA Statement on Subprime Mortgage Lending

At last year's hearing, the federal agencies had proposed the *Interagency Statement on Subprime Mortgage Lending*. Like the *Interagency Guidance on Nontraditional Mortgage Product Risks*, the Subprime Statement applied only to mortgage providers associated with an insured depository institution. Therefore, CSBS, AARMR, and the National Association of Consumer Credit Administrators (NACCA)[4] developed a parallel statement that is applicable to all mortgage providers.

Released in July 2007, the Subprime Statement has been adopted by 33 states and the District of Columbia. Again, we expect all 50 states to adopt the Statement[5] to encourage seamless and consistent supervision of the mortgage industry.

CSBS believes the Nontraditional Mortgage Product Guidance and the Subprime Statement strike a fair balance between encouraging growth and free market innovation and draconian, stern restrictions.

AARMR-CSBS Model Examination Guidelines (MEGs)

In the past year, CSBS has also initiated several new projects aimed at improving supervision of the residential mortgage industry.

For example, AARMR and CSBS have developed state Model Examination Guidelines (MEGs) for field implementation of the *Guidance on Nontraditional Mortgage Product Risks* and the *Statement on Subprime Mortgage Lending*.

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[4] The National Association of Consumer Credit Administrators represents the officials of the states and territories of the United States of America and of the Dominion of Canada, or their associates, who, by law, are vested with authority and duty to administer laws which require regulation or supervision of consumer credit agencies in the United States of America and the Dominion of Canada.

[5] To track state adoption of the CSBS-AARMR-NACCA *Statement on Subprime Mortgage Lending*, go to http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/Sub_prime_State_Impl.htm.

Released on July 31, 2007, the MEGs enhance consumer protection by providing state regulators with a uniform set of examination tools for conducting examinations of subprime lenders and mortgage brokers. In addition, the MEGs were designed to provide consistent and uniform guidelines for use by lender and broker in-house compliance and audit departments to enable them to conduct their own "regulatory style" review of their subprime lending practices. These enhanced regulatory guidelines present a new and evolving approach to mortgage supervision.

To prepare state examiners, as well as industry compliance personnel for an approach designed specifically for subprime lending platforms, CSBS and AARMR released a comprehensive Internet based MEGs User School on March 1. This school was developed to give both regulators and industry the tools needed to comprehensively examine the institution under the MEGs.

Nationwide Cooperative Protocol and Agreement for Mortgage Supervision

In December of last year, CSBS and AARMR launched a Nationwide Protocol and Agreement for Mortgage Supervision to assist state mortgage regulators by outlining a basic framework for the coordination and supervision of Multi-State Mortgage Entities (those institutions conducting business in two or more states). The goals of this initiative are to protect consumers; to ensure the safety and soundness of the institutions; to identify and prevent mortgage fraud; to supervise in a seamless, flexible and risk-focused manner; to minimize regulatory burden and expense; and to foster consistency, coordination and communication among state regulators.

In order to achieve these goals, the states agree to:

- Establish a committee comprised of state regulators to coordinate supervision;

- Determine which Multi-State Mortgage Entities will be covered by the initiative;
- Develop a supervisory program tailored to each Multi-State Entity's condition and risk profile; and
- Participate in and support the effective implementation of the supervisory program.

To date, twelve states have signed the agreement with an additional eleven states indicating a commitment to join. CSBS and AARMR expect to sign all state regulators to the protocol and agreement in 2008.

State Efforts Regarding Foreclosure Prevention

The above initiatives developed by the states will do much to improve regulation of the mortgage market. Of course, no regulatory scheme is perfect, but by enhancing coordination between states and the federal regulatory agencies, by encouraging the mortgage industry to police itself, and by increasing transparency in the mortgage market, we hope to prevent some of the more egregious fraudulent and damaging practices that contributed to the current decline of the mortgage market. In addition to our regulatory efforts, state officials have also been very active in addressing increasing foreclosures.

State Foreclosure Prevention Working Group/Loss Mitigation

State banking and mortgage regulators have been working together formally with State Attorneys General during the past year to develop a comprehensive strategy to address increasing foreclosure rates. The partnership between state regulators and attorneys general is long-standing, and had led to the largest consumer protection settlements in our nation's history, including most recently the $325 million settlement with Ameriquest.

In July 2007, representatives of 37 state attorney general offices and state banking regulators gathered in Chicago for a summit meeting on the growing crisis in subprime mortgage foreclosures. The news was alarming: nearly two million subprime mortgages with an adjustment feature, such as hybrid ARMs and option ARMs, were set to adjust between the latter part of 2007 and the end of 2008. These loans had been made with an expectation that borrowers could refinance before the rate adjusted, an expectation that is no longer justified in light of the rapid decline in home values. Many of these loans had been made based on incorrect state incomes and/or inflated appraisals, with little if any underwriting having been done to assure that borrowers could afford to make monthly payments after the initial "teaser" rate had adjusted upward. The likely outcome of this situation was an unprecedented flood of foreclosures.

A State Foreclosure Prevention Working Group, chaired by Iowa Attorney General Tom Miller, formed out of this summit meeting, to gather more information and to attempt to work with participants in the subprime mortgage industry to find ways to modify loans on a mass scale so that as many borrowers as possible could retain their homes with affordable mortgages. The Working Group consists of representatives of the attorneys general of 11 states (Arizona, California, Colorado, Iowa, Illinois, Massachusetts, Michigan, New York, North Carolina, Ohio, and Texas), two state banking departments (New York and North Carolina), and CSBS.

Since September, this Working Group has met with representatives of the 20 largest servicers of subprime mortgages. Collectively, these top 20 companies service approximately 93 percent of the nation's subprime loans. The Working Group has asked the servicers to work collaboratively to start identifying and implementing collective and consistent solutions to prevent foreclosure. The Working Group's guiding principle is simple: any solution must be in the interests of both the borrower and the investor. There are ample opportunities for improvement that will lead to benefits for investors and homeowners alike.

Beginning in November of last year, the State Foreclosure Prevention Working Group collaborated with industry and federal regulators to develop a uniform data reporting format to collect data to measure the extent of the foreclosure problem and the servicers' efforts to respond to it. However, we were frustrated that some federally regulated institutions refused to comply with our request saying that the OCC had instructed them not to share information with state regulators and law enforcement officials. As state officials, CSBS believes that objective data is necessary to make informed policy decisions and to promote initiatives that could reduce foreclosures. In addition, we believe the public has a right to know how servicers are managing the foreclosure crisis. On February 7 2008, the State Foreclosure Prevention Working Group issued the "Analysis of Subprime Mortgage Servicing Performance" data report.[6] The key findings are:

1. **Seven out of ten seriously delinquent borrowers are not on track for any loss mitigation option.** The lack of interaction between mortgage servicers and homeowners remains a major problem. While servicers have developed creative outreach efforts and increased staffing, the data shows a large gap between the number of homeowners needing loss mitigation and the number currently receiving

[6] The "Analysis of Subprime Mortgage Servicing Report" can be viewed at: http://www.csbs.org/Content/NavigationMenu/Home/StateForeclosurePreventionWorkGroupDataReport.pdf.

assistance. The data suggests that a rising number of loan delinquencies are outpacing the increase in loss mitigation efforts.

2. **Servicers have increased their use of loan modifications and other home retention options.** For those delinquent homeowners in contact with servicers, almost half (45%) are working toward a loan modification. Servicers are increasing their use of longer-term changes to the mortgage loan versus their earlier reliance on short-term repayment of forbearance agreements.
3. **Payment resets on hybrid ARMs have not *yet* been a driving force in foreclosures.** A significant percentage of subprime adjustable rate loans are delinquent before they experience payment shock from their first adjustment, reflecting weak underwriting or fraud in the origination of the loan. With so many homeowners struggling to stay afloat prior to rate resets, we need to act quickly to address these hybrid ARM loans before the payment shock due to the rate reset triggers further foreclosures.
4. **Homeowners are helping themselves.** Most delinquent loans resolved in October 2007 occurred due to the homeowner catching up on back payments. As of October, actions by homeowners, not servicers, have prevented the most foreclosures.
5. **The refinance option has nearly evaporated.** Historically, serial refinancing was the primary way that the mortgage industry and homeowners managed delinquencies in subprime loans. Despite recent interest rate cuts, the mortgage industry will not be able to refinance its way out of this crisis absent dramatic changes in available loan products or a reversal in home price declines.

The State Working Group anticipates future reporting on the data collected from servicers. The Working Group will continue to collect monthly data from servicers in order to provide public information on trends in the servicing industry as we move through the foreclosure crisis. Finally, the Working Group will continue to work directly with the top 20 subprime servicers to remove barriers to increasing the number of loan modifications.

It is my sense that many servicers are making positive efforts to avert foreclosures, but that we are still losing the larger battle to stop unnecessary foreclosures and stem the foreclosure crisis. More must be done to assist those Americans who are fighting to save their homes.

Individual State Efforts to Reduce Foreclosures

In addition to the multi-state joint effort of the State Foreclosure Prevention Working Group, individual states are taking taken the initiative to reduce foreclosures through various and evolving efforts, such as:

- Establishing foreclosure prevention hotlines, such as those in my home state of Iowa, as well as Colorado and Massachusetts;
- Hosting "road shows" of servicers in hard-hit economic areas, such as Ohio and Michigan, to promote face-to-face contact between servicers and struggling homeowners;
- Meeting directly with servicers in states such as California, Ohio, and Texas, to determine if there are solutions to local problems;
- Foreclosure moratoriums to deal with abusive lending practices of particular lenders; and

- Enactment of legislation to improve servicing practices.

Conclusion

The banking industry is eternally cyclical. A downward turn in banking always reveals bad practices and structural flaws of both institutions and supervision. As regulators we must, with an unbiased eye, collectively and collaboratively acknowledge and address the weaknesses that a turn in the industry identifies. Our highly diverse financial system is the envy of the world and allows our markets to be flexible and responsive. Thanks to our decentralized regulatory system, our financial institutions are competitive internationally and locally. However regulators and legislators address the current market failings, it should be in a way that preserves the diversity of financial institutions and supervision that has made our economy both nimble and strong.

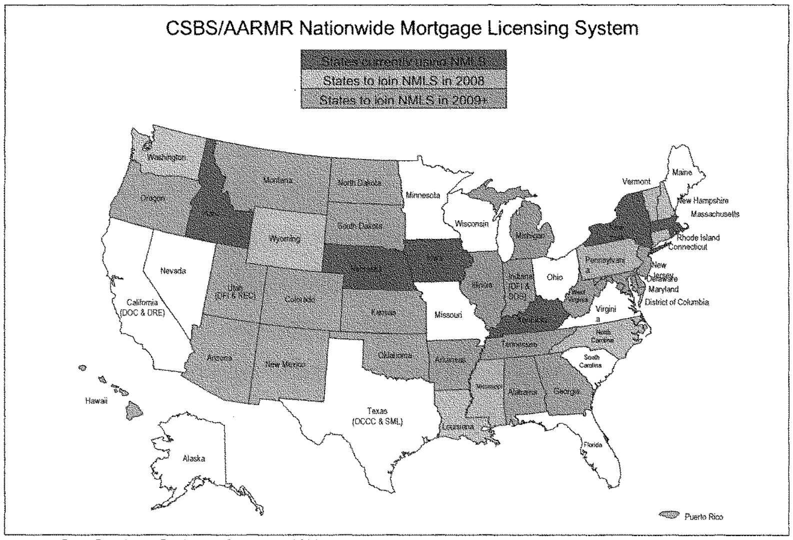
We recognize that our regulatory structure at both the state and federal level is sometimes complex for both the industry and consumers to navigate. There is a need for improved coordination and cooperation among functional regulators. CSBS has been actively engaged in efforts to enhance coordination as we all work to develop a system of supervision that ensures safety, soundness, and consumer protection, but still provides economic stability and industry innovation.

CSBS looks forward to continuing to work with the federal regulators and Congress to address the needs and regulatory demands of an ever evolving financial system in an environment that fosters the strongest economy possible while protecting consumers, minimizing regulatory burden, and ensuring access to the broadest range of financial opportunity.

I thank you for the opportunity to testify today, and look forward to any questions you may have.

Appendix

Exhibit A—Schedule of State Participation in the CSBS/AARMR NMLS



State Regulatory Registry LLC, January 2008

2008

ANALYSIS OF SUBPRIME MORTGAGE SERVICING PERFORMANCE

DATA REPORT NO. 1
FEBRUARY 2008

STATE FORECLOSURE PREVENTION WORKING GROUP

Executive Summary

In the summer of 2007, the state attorneys general and state banking regulators formed the State Foreclosure Prevention Working Group to work with servicers of subprime mortgage loans to identify ways to work together to prevent unnecessary foreclosures. The touchstone of the State Working Group is to work to prevent those foreclosures where the homeowner has the desire and reasonable ability to make payments on a mortgage loan and the investors that own the mortgage loan have a financial incentive to modify the loan rather than incurring the significant costs and likely greater losses from foreclosing on the loan. In our experience with homeowners in our states, unnecessary foreclosures had been occurring all too often because the system for servicing subprime mortgage loans was not designed to conduct large numbers of loan modifications or other work-outs for homeowners in distress.

The State Working Group collaborated with industry and federal regulators to develop a uniform data reporting format to collect data to measure the extent of the foreclosure problem and the servicers' efforts to respond to it. As state officials, we believe that objective data is necessary to make informed policy decisions and to promote initiatives that could reduce foreclosures. In addition, we believe the public has a right to know how servicers are managing the foreclosure crisis. This report is our first effort to provide the public with data on servicer activities. Our key findings are:

1. **Seven out of ten seriously delinquent borrowers are not on track for any loss mitigation option**. The lack of interaction between mortgage servicers and homeowners remains a major problem. While servicers have developed creative outreach efforts and increased staffing, the data shows a large gap between the number of homeowners needing loss mitigation and the number currently receiving assistance. Our data suggests that a rising number of loan delinquencies are outpacing the increase in loss mitigation efforts.

2. **Servicers have increased their use of loan modifications and other home retention options**. For those delinquent homeowners in contact with servicers, almost half (45%) are working toward a loan modification. Servicers are increasing their use of longer-term changes to the mortgage loan versus their earlier reliance on short-term repayment or forbearance agreements.

3. **Payment resets on hybrid ARMs have not *yet* been a driving force in foreclosures**. A significant percentage of subprime adjustable rate loans are delinquent before they experience payment shock from their first adjustment, reflecting weak underwriting or

fraud in the origination of the loan. With so many homeowners struggling to stay afloat prior to rate resets, we need to act quickly to address these hybrid ARM loans before the payment shock due to the rate reset triggers further foreclosures.

4. **Homeowners are helping themselves**. Most delinquent loans resolved in October 2007 occurred due to the homeowner catching up on back payments. As of October, actions by homeowners, not servicers, have prevented the most foreclosures.

5. **The refinance option has nearly evaporated.** Historically, serial refinancing was the primary way that the mortgage industry and homeowners managed delinquencies in subprime loans. Despite recent interest rate cuts, the mortgage industry will not be able to refinance its way out of this crisis absent dramatic changes in available loan products or a reversal in home price declines.

We reach these preliminary conclusions based on somewhat limited data. Some major national banks that service subprime loans have declined to provide the State Working Group with data based on advice or direction from the Office of the Comptroller of the Currency. Another federally-chartered thrift refused to provide data based on its participation in the industry-led HOPE NOW data collection effort. We call on the OCC to urge national banks to report data to the State Working Group, so that we will be able to provide a complete picture of the subprime servicing market.

In addition, we renew our calls for systematic, long-term solutions to efficiently deal with subprime loans originated in recent years. While there is an industry-led effort to identify a set of loans for "fast track" modifications, we believe this effort only scratches the surface of the need for a more efficient and systematic approach. A continued insistence that each delinquent loan needs intensive one-on-one attention will hamstring efforts to prevent large numbers of foreclosures. As a result, millions of homeowners will lose their homes unnecessarily, impacting not only those families, but their neighbors and communities as well. We must do better.

Section I: The State Foreclosure Prevention Working Group and the Need for Public Data to Measure Servicer Performance in Preventing Unnecessary Foreclosures

The State Foreclosure Prevention Working Group ("State Working Group")[1] formed in the summer of 2007 after representatives of 37 state attorney general offices and several state banking regulators met to discuss the growing foreclosure crisis. States have long been active in addressing abusive lending practices, either through legislation[2] or enforcement.[3] But unlike traditional law enforcement efforts, the States face the challenge of addressing the devastating impact of elevated foreclosure levels on our citizens and state and local economies.

Foreclosures impact much more than the homeowner and lender involved. While devastating for the individual homeowners and their families, foreclosures also have a negative impact on the property values of their neighbors. The Center for Responsible Lending estimates neighborhood property values will decline $202 billion due to subprime foreclosures, or approximately $5,000 for each homeowner living near a foreclosed property.[4] Similarly, the Woodstock Institute found that each foreclosure within a city block of a single-family home reduces that home's property value by approximately 1%.[5]

While home lending is financed globally, the impact of foreclosures is inherently local. According to the U.S. Conference of Mayors, the foreclosure crisis will result in a loss of $166 billion in gross domestic product of metropolitan areas.[6] Foreclosures are also associated with an increase in crime and lead to vacant and abandoned properties. City, county, and state governments must deal with these issues and bear significant costs from foreclosures.

[1] The State Working Group consists of representatives of the Attorneys General of 11 states (Arizona, California, Colorado, Iowa, Illinois, Massachusetts, Michigan, New York, North Carolina, Ohio, and Texas), two state bank regulators (New York and North Carolina), and the Conference of State Bank Supervisors.

[2] North Carolina passed the first state predatory lending law in 1999. Since that time, the majority of states have enacted similar laws to supplement the Home Ownership and Equity Protection Act (HOEPA), the 1994 federal predatory lending law, and some states have recently enacted new laws to address abuses in the subprime mortgage market.

[3] State enforcement actions against mortgage lenders have resulted in the return of almost $1 billion to state citizens.

[4] *Subprime Spillover*, Center for Responsible Lending, revised January 18, 2008, available at: http://www.responsiblelending.org/pdfs/subprime-spillover.pdf.

[5] *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, Dan Immergluck and Geoff Smith, available at: http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1701_immergluck.pdf.

[6] *The Mortgage Crisis*, U.S. Conference of Mayors, November 2007, available at: http://usmayors.org/metroeconomies/1107/report.pdf.

Of particular concern to the States last summer was the anticipated increase in foreclosures nationwide due to the escalation in monthly payments (commonly known as "payment shock") for subprime adjustable rate mortgage loans ("hybrid ARM" or "ARM") as those loans adjusted through late 2007 and 2008.[7] While not the sole driver of foreclosures, this impending wave of loans with increased payments suggested a need for proactive efforts to refinance or modify these loans before they led to significant increases in the number of defaults and foreclosures.

Led by Iowa Attorney General Tom Miller, the goal of the State Working Group is to reduce the number of foreclosures by encouraging loan modifications and other sustainable, long-term solutions. Given the expected increases in foreclosures and our assessment of structural flaws in the fractured and complex mortgage origination and securitization system, the State Working Group decided to focus its efforts on the prevention of *unnecessary* foreclosures, foreclosures where the homeowner has the desire and reasonable ability to make payments on a mortgage loan and the secondary market investors that own the mortgage loan have a financial incentive to modify the loan rather than incurring the significant costs and likely greater losses from foreclosing on the loan.

In September and November 2007, the State Working Group met with representatives of the 20 largest servicers[8] of subprime mortgages. Collectively, these top 20 companies service approximately 93 percent of the nation's subprime loans. The State Working Group asked these servicers to identify and implement comprehensive and systematic programs to prevent unnecessary foreclosures.

Any effort to reduce foreclosures requires a clear-eyed assessment of the underlying causes of the foreclosure crisis. There is no one cause for the foreclosure crisis – and accordingly, no single solution can solve it. However, the State Working Group believes that weak underwriting and mortgage origination fraud played a central role in the scope and scale of the foreclosure crisis. Servicers now have to address an unprecedented number of loans that never had a realistic prospect of fully performing.

[7] For a fuller discussion of the hybrid ARM problem, see *Overview of the Subprime Foreclosure Crisis*, by Iowa Assistant Attorney General Patrick Madigan, available at: http://www.iowa.gov/government/ag/latest_news/releases/sept_2007/Foreclosure_analysis.pdf.

[8] A servicer is an agent that collects payments on mortgage loans and transfers those payments to the investors who own those loans. When a borrower misses payments, the servicer attempts to contact the borrower to collect the outstanding amount owed. In the event the borrower fails to pay the outstanding amount, the servicer initiates and manages the foreclosure process.

In recent years, the subprime market became a race to the bottom. Because of the capital markets' voracious appetite for securities backed by subprime mortgage loans, originators engaged in intense competition to produce volume. This emphasis on quantity over quality resulted in a lowering of underwriting standards and an increase in risky loan features. As a result, beginning as early as 2005 and continuing throughout 2006 and the first half of 2007, lax underwriting standards prevailed and long-standing lending norms were routinely ignored. In addition, as demonstrated by the States' Ameriquest Mortgage Company investigation and settlement, loan origination fraud became more common, particularly inflated appraisals and stated income fraud.

This view is bolstered by industry studies. For example, the rating agency Fitch recently reviewed a small sample of loans that defaulted within the first 12 months after securitization and concluded that fraud played a major role. Fitch concluded that "poor underwriting quality and fraud" may account for as much as 25% of the defaults.[9] Fitch further commented that, "[t]here was the appearance of fraud or misrepresentation in almost every file."[10]

Weak or non-existent underwriting coupled with high levels of origination fraud combined to produce loans that had no reasonable prospect of being repaid. Rather, these loans were originated based on the assumption that housing appreciation would continue indefinitely and that when borrowers ran into trouble, they would refinance or sell. While this approach worked for a few years, when the inevitable leveling off and decline in housing prices began, the refinance option was cut off. Because many loans were originated without regard for the borrowers' ability to pay, only in the last year have we begun to see the disastrous results of this reckless lending.

Servicers are being asked to clean up the mess caused by reckless origination practices. While the servicing system was well-designed to deal with traditional payment defaults due to life events such as a job loss or divorce, the servicing system was not designed to re-underwrite a massive number of loans that are defaulting due to failures in loan origination, such as loans originated with built-in payment shock, failures by lenders to assess a borrower's ability to repay, or hidden fraud associated with inflated appraisals or falsified incomes.

In our meetings, the State Working Group found much common ground with the intentions and the initiatives of mortgage loan servicers. Servicers agreed that it was in their interest and in the interests of secondary market investors who own securities backed by

[9] *Up to 25% of Subprime Losses Blamed on Fraud*, Inside B&C Lending, November 30, 2007, at 5.
[10] *Id.*

mortgage loans to work out loan delinquencies and avoid foreclosures whenever reasonably possible. The leading servicers subscribed to the "Dodd Principles," developed by Senator Christopher Dodd in May 2007.[11] All of the servicers were implementing strategies to notify borrowers in advance of the ARM reset date. All were increasing staff to deal with the increased loss mitigation demand. Most were enhancing efforts to communicate with delinquent borrowers, including contracting with third party non-profit agencies for that purpose.

While there was considerable agreement among servicers at the senior management level that efforts to prevent foreclosures needed to be expanded, the State Working Group expressed concern that the corporate pronouncements were not being adequately implemented at the ground level. The experience of the State Working Group as well as anecdotal reports from consumers and housing counselors, indicated that it remained difficult to contact loss mitigation staff; that foreclosures were proceeding even when borrowers had reasonable options to preserve homeownership; that temporary and unrealistic short-term repayment plans were still the most common loss mitigation method; and that loan modifications were rarely offered. In short, a considerable disconnect existed between words and actions, particularly as to the availability of loan modifications.

To move past anecdotes, the State Working Group recognized the need for consistent data to verify the performance of the servicers' foreclosure avoidance programs. The State Working Group developed a "call report" format for monthly data reporting purposes. The call report form was circulated to a number of federal banking regulators and servicers for comment and revision. The final call report was intended to improve data reporting, ensure that data was uniform, and to reduce the burden on servicers facing multiple requests for data from a variety of sources, including state and local government agencies. This report is the first public discussion of this data collection effort.

[11] The Dodd Principles can be found at: http://dodd.senate.gov/multimedia/2007/050207_Principles.pdf.

Section II. October 2007 Data Reported by Subprime Mortgage Loan Servicers

Thirteen of the top 20 servicers provided the requested data for the month of October 2007. These servicers represent approximately 58% of the total subprime servicing market.

Six servicers have either refused to provide data to the State Working Group or are in negotiations with the State Working Group to address confidentiality concerns. Of these six, Chase and Wells Fargo refused to provide data based on advice or direction from the Office of the Comptroller of Currency ("OCC"), the regulator of national banks. The State Working Group contacted the OCC to encourage it to permit these banks to provide data to the State Working Group,[12] but the OCC has declined to so.[13] Washington Mutual and Chase have also refused to provide data based on their participation in the HOPE NOW Alliance's data project.[14]

The failure of these federally-chartered institutions to provide data hampers the ability of the State Working Group to provide a comprehensive picture of the subprime mortgage servicing marketplace,[15] and we are extremely disappointed in their refusal to cooperate with our efforts. As state and local governments work to manage the impact of high foreclosures, we are dismayed that some servicers regulated at the federal level have refused to provide us with aggregate information essential to our efforts. In this time of foreclosure crisis, we need to work together to solve problems, and we call on the OCC to encourage national bank servicers to work voluntarily with the States.

As this is the first collection of data in this format, the State Working Group has attempted to review the data thoroughly to identify errors or inconsistent reporting. Based on the

[12] Letter to Comptroller of Currency John Dugan from Mark Pearce, North Carolina Deputy Commissioner of Banks, January 4, 2008.

[13] Letter to North Carolina Deputy Commissioner of Banks Mark Pearce from Comptroller of the Currency John Dugan, February 1, 2008 (expressing concern that the States' project would produce "inconsistent and incomplete" data that would "not be constructive to achieving an accurate picture of delinquencies and loss modification efforts").

[14] The HOPE NOW Alliance is a collaboration of major mortgage servicers, mortgage market participants, and housing and credit counselor organizations with the encouragement of the U.S. Treasury Department and U.S. Department of Housing and Urban Development. We support the subsequent industry-led HOPE NOW data collection effort and have discussed opportunities with HOPE NOW to develop consistent definitions and reporting formats.

[15] While we respect the OCC's concern regarding incomplete data (*see* footnote 13), the most significant gap in our information is due to the refusal of national banks with large subprime mortgage servicing portfolios to provide us with data. This gap far exceeds any likely distortions or inaccuracies due to definitional differences.

pressing need for public information of loss mitigation activities, the State Working Group has decided to provide preliminary data on this first month's reporting. It is expected that this data may be revised as we continue our review of the data reporting and as servicers modify their systems to more fully report information we have requested.

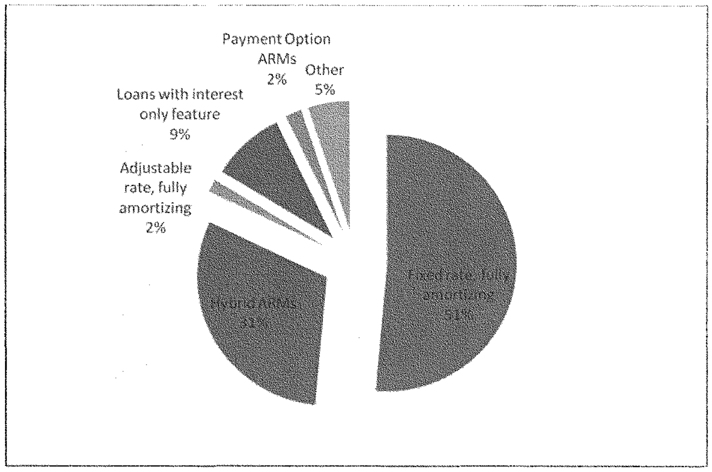
A. Summary of Servicing Activity of Reporting Servicers:

As noted above, thirteen servicers provided data for their servicing activities for the month of October 2007 ("Reporting Servicers"). These thirteen companies service approximately 58% of the total loans in the subprime servicing market. In addition, seven of these servicers also service prime loans.

Types of Subprime and Alt-A Loans Serviced

As of the end of October, Reporting Servicers serviced 5,110,678 subprime and Alt-A loans. The distribution of loan products is listed below in Figure 1.

Figure 1: Subprime and Alt-A Loan Distribution by product type

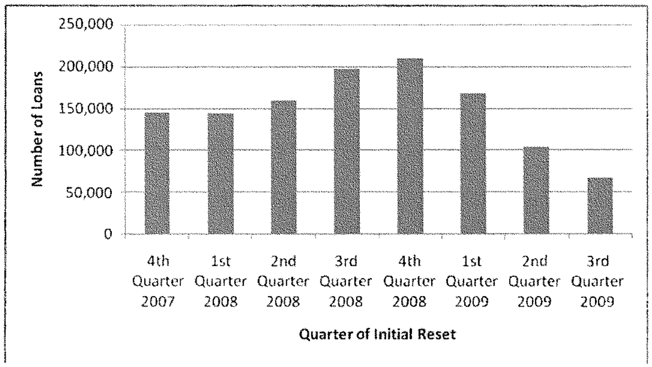


Thus, half of the subprime and Alt-A loans in our data set were fixed-rate, fully-amortizing loans. Hybrid ARMs accounted for 31% of the total subprime and Alt-A market. Although we are reporting data for payment option ARMs, we believe this data undercounts the true number of these loan products due to the fact some loans with payment option features may have been allocated in other categories of loan products. In order to avoid double counting, our data collection required servicers to report a loan in only one category; however, it is possible to have multiple combinations with a negative amortization feature, such as a hybrid ARM with an option for negative amortization.

<u>Payment Resets for Subprime and Alt-A Loans</u>

Reporting Servicers provided information regarding the time horizon for loans to reach their first payment change date, otherwise known as the "initial reset." The State Working Group and other policymakers believe that modification of subprime hybrid ARMs will help prevent foreclosures caused by the significant payment increases caused by the initial rate resets of these loans. Based on October data, Figure 2 provides a schedule for when subprime and Alt-A adjustable rate loans will reach their first payment reset:

Figure 2: Subprime and Alt-A Adjustable Loan Resets by Quarter through 2009



This data highlights the fact that there is still a large pool of subprime loans facing their first reset in 2008 and 2009, with the biggest spikes in the third and fourth quarters of this year. Time is running out on implementing systemic solutions to enable the modification of many of these loans into a more sustainable loan product.

In addition to the schedule for resetting loans, Reporting Servicers provided information regarding the current payment status of these loans prior to the first reset. Approximately 31% of these loans are currently delinquent by 30 days or more. This data shows that a significant number of homeowners with subprime loans are currently experiencing difficulty in paying their loan ***prior*** to any increase in monthly payment associated with payment shock. This high delinquency rate for loans early in their loan term reflects the impact of weak underwriting and fraud in the subprime loan origination system. For example, over 21% of homeowners who will not experience their first payment reset until the third quarter of 2009 are already experiencing difficulty in making their mortgage payments.

Table 1: Current delinquency rates for Subprime and Alt-A Loans, by quarter of first payment reset

Quarter for First Payment Reset	30+ Days Past Due (%)[16]
4th Quarter 2007	32.4%
1st Quarter 2008	32.5%
2nd Quarter 2008	34.2%
3rd Quarter 2008	35.5%
4th Quarter 2008	35.4%
1st Quarter 2009	30.5%
2nd Quarter 2009	22.9%
3rd Quarter 2009	21.4%
Average	31.9%

The high rate of delinquency prior to reset confirms that modification of performing subprime loans prior to reset is only a partial, first step to addressing the foreclosure crisis. The strict criteria for qualifying for fast-track modification programs, such as those found in the American Securitization Forum (ASF) framework,[17] will limit the impact of these proposals.

On the other hand, the data reported to us for October does not demonstrate that payment resets are a major component of current delinquencies. Only 3% of the *currently* delinquent subprime and Alt-A loans were loans that entered delinquency in the first three months after an interest rate reset. By contrast, one out of every three (33%) currently delinquent subprime and Alt-A loans is a loan with an initial rate reset coming up in the next two years. In short, we believe that a significant percentage of subprime adjustable rate loans are performing very poorly in advance of a reset, and that the reset payment only increases the burdens on homeowners already struggling to stay afloat.

[16] Based on the definitions used by the State Working Group (see Appendix C), a loan 30 days or more past due means the homeowner has typically missed two monthly payments. We used the 30 days delinquency level to demonstrate the significant degree of trouble that homeowners with subprime loans are already having in managing their loans, prior to the 20-30% monthly payment increase that will occur after the loan reaches the initial interest rate adjustment.

[17] The ASF Framework is sometimes called the "Paulson Plan" in reference to U.S. Treasury Secretary Henry Paulson, who worked closely with ASF and the HOPE NOW Alliance to support the development of the "fast track" approach. The ASF Framework can be found at: http://www.americansecuritization.com/uploadedFiles/FinalASFStatementonStreamlinedServicingProcedures.pdf.

Delinquency and Default in Subprime and Alt-A Loans

As of the end of October, over 500,000 subprime and Alt-A loans were delinquent by 90 days or more. Almost 15% of subprime loans serviced by Reporting Servicers were delinquent by 60 or more days. Table 2 provides a listing of total delinquencies.

Table 2: Subprime and Alt-A delinquency rates by severity

Days Past Due	Number of Loans	Percent of Loans
30 to 59 days	356,850	6.98%
60 to 89 days	186,695	3.65%
90 days or over	556,578	10.89%
Total	1,100,123	21.53%

Of the million plus subprime loans experiencing delinquency, *over a quarter of a million are currently in the process of foreclosure.* Reporting Servicers are holding close to 100,000 foreclosed properties for sale. As the foreclosure crisis unfolds, the State Working Group has concerns that a build-up in foreclosed home inventory will unduly depress local home prices in affected communities.

One concern among investors has been the performance of loans previously modified by the servicer.[18] The Reporting Servicer data shows that, for the month of October, only 2% of the delinquent loans being serviced had been modified in the previous year. As the level of loan modifications increase, this figure will be important to monitor to see if loan modifications are leading to sustainable homeownership or if the modifications fail to solve the challenges homeowners face in affording their subprime loans.

B. Loss Mitigation and Loan Modification Efforts

When the State Working Group met with the top subprime servicers last fall, a pressing issue was inconsistent or inadequate reporting of loss mitigation efforts. For instance, some servicers reported making loan "modifications" that other servicers would have characterized as

[18] Investors have concerns that some servicers, primarily those affiliated with the originating lender, may have incentives to implement unsustainable repayment plans to depress or defer the recognition of losses in the loan pool in order to allow the release of collateral provided by the lender to guarantee performance of the loans for a certain period of time.

a "repayment plan." Thus, the state data report prescribes precise definitions for loan modifications, repayment plans, and other loss mitigation outcomes. Generally speaking, loss mitigation efforts can be divided into two categories: 1) outcomes that lead to home retention, such as a loan modification, repayment plan, or short-term forbearance, and 2) outcomes that result in the homeowner surrendering possession of the home without a foreclosure, such as a short sale or a deed in lieu of foreclosure. In addition to these efforts, homeowners may catch up on back payments in one lump sum payment in order to "reinstate" or make their account current or they may pay off their existing loan through a refinancing.

In addition to collecting information on the implementation of loss mitigation efforts, the state data request also collected information regarding loss mitigation efforts that had "closed" versus loss mitigation efforts in progress. This distinction helps identify not only what has happened, but the types of efforts that are underway.

The October data from Reporting Servicers shows that most mortgage payment delinquencies are resolved by action taken by the homeowners themselves. Of the loss mitigation efforts closed in October, 73% of all resolutions were due to the borrower bringing the account current. This demonstrates that it is mostly the homeowners themselves that are resolving their financial difficulties. We are concerned this reliance on homeowners to solve most of these loan problems is not sustainable at its current level.

Only 4% of homeowners refinanced their home or paid off the loan. This is a marked change. In the recent past, due to rapidly rising home prices, many borrowers were able to refinance or sell if they got into trouble and this in turn masked the true impact of poor underwriting and origination fraud. With home prices now leveling off or falling in many parts of the country, this option is no longer available and loans that would have previously paid off remain in the servicing portfolio. From conversations with servicers, we believe that serial refinancing was the primary way that many loan delinquencies and foreclosures had been avoided.

The small number of current refinances reinforces the notion that many borrowers are stuck in their current loan due to declining housing values or the greatly reduced level of subprime credit. If these mortgage loans had been underwritten prudently in the first instance, then declining home values would not have necessarily spurred the levels of foreclosure we are seeing. If placed in a loan with an affordable monthly payment, those homeowners who choose to stay in their homes, despite the loss of equity, would have that option. However, when an unaffordable loan (made possible through weak underwriting, risk layering, or origination fraud) is coupled with a decline in home values, homeowners are faced with no option other than loan modification or foreclosure.

For other loss mitigation efforts, Table 3 below shows the overall level of various loss mitigation efforts that were closed in the month of October. Loan modifications represent 45% of all "home retention"[19] tools used by servicers in October 2007, supporting servicer statements that they have increased their level of loan modification efforts. In earlier years, short-term repayment plans were significantly more common than loan modifications.

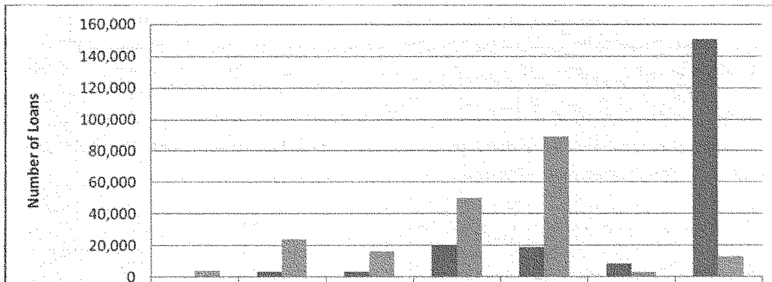
[19] By home retention tools, we mean the strategies servicers use with homeowners to help them stay in their home with their current mortgage loan, such as forbearance agreements, repayment plans, and loan modifications. Home retention tools do not include short sales or deeds in lieu (as the homeowner moves out of the home) or refinance/paid in full (as the borrower gets a new loan) or reinstatement (where the borrower simply catches up).

Table 3: Loss mitigation outcomes closed in month of October

Loss Mitigation Outcome	Number	Percent of Total
Deed in lieu	356	0.17%
Short sale	3,456	1.68%
Forbearance	3,129	1.52%
Repayment plan	20,486	9.98%
Modification	19,082	9.30%
Refinance or paid in full	8,242	4.02%
Reinstatement/Account made current	150,519	73.33%
Total	205,270	100.00%

The trend toward loan modifications is further supported by looking at loss mitigation efforts in progress. As of the end of October, 45% of all loss mitigation efforts in process were directed to loan modifications, whereas less than 7% were directed toward simply bringing the account current. The State Working Group hopes this indicates that servicers have recognized the need for loan modifications and have implemented systems to make them happen more frequently. However, this apparent trend will not be clear until it is established by the closed loss mitigation outcome data in future months. Overall, over 150,000 delinquent loans were in the process of receiving a loan modification or other home retention accommodation at the end of October. Figure 3 below shows the distribution of loss mitigation efforts in process, and compares it to the closed loan modifications to show trends.

Figure 3: Loss mitigation efforts in progress versus closed mitigations, as of end of October



	Deed in lieu	Short sale	Forbearance	Repayment plan	Modification	Refinance or paid in full	Made current
Number Closed	356	3,456	3,129	20,486	19,082	8,242	150,519
Number in Process	3,662	23,551	16,120	49,704	88,907	2,666	12,503

One disturbing result in the data is the extent of loss mitigation efforts as compared with the level of serious subprime delinquencies. The sum total of all loss mitigation efforts surveyed account for only 24% of seriously delinquent (60 days+) subprime loans. This means that seven out of ten seriously delinquent homeowners are not currently on track to have *any* loss mitigation outcome. Aside from errors in data reporting, this disparity may reflect a lack of servicer capacity to manage the level of delinquent loans they service, a lack of success in contacting delinquent borrowers, or investor resistance to loss mitigation (or a combination of some or all of the above). The State Working Group will follow up with servicers to better understand this troubling gap.

Types of Loan Modifications

In order to understand better the types of loan modifications occurring, the State Working Group gathered information on the typical type and duration of loan modifications completed. Our data request attempted to gather information as to whether the loan modification used was an interest rate modification (and if so, what type), a term modification (e.g., extending the term of the loan), or a reduction in the principal balance of the loan. In addition, we attempted to learn whether the loan modification was set for the life of the loan or whether the modification was for a set time period (e.g., 2 years).

Some servicers had not, as of our data collection for October data, implemented a tracking system to provide this information. Given the data limitations and spotty reporting, we have decided not to include specific dispersion tables in this first report. Servicers are working to improve their systems and we hope to be able to provide reliable information on this area in future reports. However, from first blush, it appears loan modifications that are permanent for the life of the loan account for a significant proportion of all modifications, and that freezing the interest rate at the start rate for ARMs is the most common loan modification technique. We expect the loan rate freeze to continue and expand under the fast-track loan modification protocol in the ASF Framework, but are concerned that as some servicers adopt the ASF Framework, they may stop offering permanent loan modifications.

C. Variations among Subprime Servicers

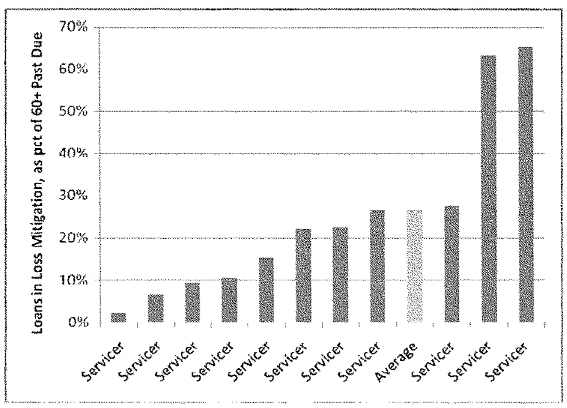
The subprime servicing industry is not a monolith. For instance, seven of the Reporting Servicers only service subprime loans, while the remaining service a varying proportion of prime and subprime loans. In addition, five of the Reporting Servicers only service subprime loans originated by others, one services only loans originated by an affiliate, and the rest service a mixture of loans originated by an affiliate and loans originated by others. Despite these different characteristics, our review of the October reporting does not indicate an obvious difference driven by the business model of the subprime servicer.

Types of Loan Modifications

The State Working Group examined each Reporting Servicer to identify the most-used loss mitigation technique. Repayment plans are the most-used technique for five of the Reporting Servicers, and loan modifications for four others. Reinstatement is the most-used technique for three others. Loss mitigation tools leading to home loss (deed in lieu and short sale) are rare. In addition, refinances and pay-offs are rare among closed loss mitigation efforts, with only one servicer reporting that as the most-used loss mitigation tool. Given the subprime industry's previous high level of refinance, the October data confirms the marked change in dynamics of the subprime market. This data supports the view that the industry will not be able to refinance its way out of this problem.

While the loss mitigation tools used tended to be similar, the State Working Group found significant differences in the level of seriously delinquent loans in loss mitigation. Three servicers had loss mitigations in process that amounted to less than 10% of the number of loans seriously (60 days+) delinquent. On the other hand, two servicers had loss mitigations in process that exceeded 60% of their seriously delinquent loans. This large disparity may reflect significant differences among servicers in their ability to manage the volume of seriously delinquent loans with existing staff or weaknesses in their outreach programs to contact homeowners.

Figure 4: Loss mitigations in process, as a percentage of 60+ days past due



Delinquency and Foreclosure

There was a significant disparity in delinquency rates among the Reporting Servicers. For instance, three servicers reported serious (90 day+) delinquencies of 6% or less of their subprime and Alt-A portfolio, while seven servicers reported delinquency rates of 16% or greater. For loans in the process of foreclosures, all but one servicer reported subprime and Alt-A loans in foreclosure at a rate between 3% and 8% of their total number of subprime and Alt-A loans serviced. The remaining servicer reported that 15% of its subprime and Alt-A loans were in process of foreclosure.

Section III. The State Working Group's Next Steps and Future Reporting

The State Working Group anticipates future reporting on the data collected from servicers. The State Working Group will continue to collect monthly data from Reporting Servicers in order to provide public information on trends in the servicing industry as we move through this foreclosure crisis. As this first report was going to press, the State Working Group completed the collection of data for November 2007 servicing activity, and that data should be forthcoming on the Conference of State Bank Supervisors' website at www.csbs.org.

A preliminary review of the November 2007 data suggests that subprime and Alt-A delinquency rates continued to rise in November; however, loss mitigations in process failed to keep pace. The November data also indicates that the overwhelming number of resolutions continues to be due to the efforts of the borrower. These early trends confirm our concern with servicing staffing levels and the inadequacy of current efforts to prevent unnecessary foreclosures.

In addition, the State Working Group intends to update its data request to begin tracking information related to the loans covered by the ASF Framework and other commitments made by servicers regarding their practices. Since these programs are just now being implemented, we may be a few months from seeing measurable outcomes from those efforts. The State Working Group supports the ASF's efforts in both developing methods for modifying more loans and in tracking outcomes, and we hope they continue to expand the numbers of loans that merit the fast-track approach. Given the increasing negative trends in the performance of loans *other* than subprime hybrid ARMs, such as payment option ARMs and Alt-A loans, we need to move quickly to address the subprime loans so we can begin to expand our efforts to deal with these other types of loans needing attention.

The State Working Group continues to seek cooperation from a few servicers that have refused to provide this important data to our group. In particular, we ask the Office of the Comptroller of the Currency to urge national banks to provide this data to the State Working Group. The State Working Group has repeatedly emphasized that this is a voluntary and cooperative effort to prevent unnecessary foreclosures and has made assurances to the participating servicers that the State Working Group is not attempting to exercise jurisdiction over national banks or federal thrifts. Furthermore, we believe the HOPE NOW data collection effort complements our data collection efforts and that our projects are not mutually exclusive. In our view, this crisis is too important to waste time on turf battles between regulators.

Finally, the State Working Group will continue to work directly with the top twenty subprime servicers to remove barriers and obstacles to increasing the numbers of loan modifications. It is our sense that many servicers are making positive efforts to avert foreclosures, but that we are still losing the larger battle to stop unnecessary foreclosures and stem the foreclosure crisis.

APPENDIX A: CONSOLIDATED STATE REPORT FOR MORTGAGE SERVICERS
DATA AS OF OCTOBER 31, 2007

Consolidated State Report for Mortgage Servicers

Consolidated Report as of October 31, 2007 for 13 Companies

All dollar amounts are the unpaid principal balance (UPB) and are in thousands (000's).
All numbers of loans are the actual number.

OPERATIONAL PROFILE	Number	%	UPB	%
Total Loans Serviced	15,494,510	100.00%	2,408,583,039	100.00%
Serviced loans originated and funded by an unaffiliated party	8,537,738	55.10%	1,376,616,094	57.15%
Serviced loans where originator or funder is affiliated with the servicer	6,956,772	44.90%	1,031,966,945	42.85%
Serviced loans secured by owner-occupied residence*	13,132,971	84.76%	2,083,531,582	86.50%
Serviced loans for investment or second residence property*	2,344,960	15.13%	322,199,402	13.38%
Loans which are secured by a first mortgage only*	11,452,989	73.92%	2,112,461,654	87.71%
Loans which are secured by a second mortgage only*	1,674,117	10.80%	84,479,200	3.51%
Loans which you service both the first and second mortgage*	2,059,295	13.29%	235,451,061	9.78%
*Reported data reconciles within 2%.				
Prime Loans (7 servicers reporting)	10,281,531	100.00%	1,604,081,519	100.00%
Fixed rate, fully amortizing	8,507,815	82.75%	1,137,278,844	70.90%
Hybrid ARMs (2/28, 3/27s, or similar)	1,194,406	11.62%	269,195,548	16.78%
Adjustable rate, fully amortizing	36,214	0.35%	5,582,027	0.35%
Loans with interest only feature	140,151	1.36%	41,617,655	2.59%
Payment Option ARMs and other loans with negative amortization feature	402,870	3.92%	150,403,320	9.38%
Other	75	0.00%	4,126	0.00%
Subprime & Alt-A Loans (13 servicers reporting)	5,110,678	100.00%	802,376,256	100.00%
Fixed rate, fully amortizing	2,631,873	51.50%	304,936,374	38.00%
Hybrid ARMs (2/28, 3/27s, or similar)	1,560,932	30.54%	285,270,151	35.55%
Adjustable rate, fully amortizing	80,207	1.57%	15,654,653	1.95%
Loans with interest only feature	470,876	9.21%	127,033,354	15.83%
Payment Option ARMs and other loans with negative amortization feature	104,390	2.04%	38,536,530	4.80%
Other	262,400	5.13%	30,945,193	3.86%

DELINQUENCY BY QUARTER OF INITIAL RESET

Number of Prime Loans

		30+ Days Past Due		Individual Company %		
		Number	%	High	Low	Median
4th Quarter 2007	30,189	4,001	13.25%	13.39%	13.12%	13.26%
1st Quarter 2008	24,291	2,134	8.79%	9.05%	8.65%	8.85%
2nd Quarter 2008	26,866	1,971	7.34%	10.00%	5.88%	7.79%
3rd Quarter 2008	33,198	2,954	8.90%	15.38%	5.72%	9.64%
4th Quarter 2008	24,306	1,579	6.50%	7.00%	6.41%	6.71%
1st Quarter 2009	18,519	1,049	5.66%	25.00%	5.36%	7.49%
2nd Quarter 2009	33,267	1,291	3.88%	16.00%	2.68%	4.12%
3rd Quarter 2009	34,028	1,550	4.56%	7.41%	2.85%	4.85%
Eight Quarter Total	224,664	16,529	7.36%			
Percent of Total Serviced	2.19%					
Percent of non-fixed rate products	12.67%					

UPB of Prime Loans

		30+ Days Past Due		Individual Company %		
		UPB	%	High	Low	Median
4th Quarter 2007	8,187,793	1,142,475	13.95%	14.62%	13.45%	14.03%
1st Quarter 2008	6,065,091	568,986	9.38%	9.66%	9.02%	9.34%
2nd Quarter 2008	6,381,559	497,737	7.80%	8.82%	6.42%	8.34%
3rd Quarter 2008	7,837,941	754,791	9.63%	10.60%	5.76%	9.62%
4th Quarter 2008	5,497,059	391,820	7.13%	7.85%	6.99%	7.42%
1st Quarter 2009	4,158,036	260,876	6.27%	17.25%	5.81%	8.92%
2nd Quarter 2009	8,301,489	322,462	3.88%	25.01%	2.64%	4.13%
3rd Quarter 2009	8,105,101	393,782	4.86%	5.22%	2.78%	3.60%
Eight Quarter Total	54,534,068	4,332,928	7.95%			
Percent of Total Serviced	3.40%					
Percent of non-fixed rate products	11.68%					

DELINQUENCY BY QUARTER OF INITIAL RESET

Number of Sub-Prime & Alt-A Loans

		30+ Days Past Due		Individual Company %		
		Number	%	High	Low	Median
4th Quarter 2007	144,857	47,630	32.88%	46.58%	23.22%	31.88%
1st Quarter 2008	143,825	45,743	31.80%	40.16%	23.59%	32.21%
2nd Quarter 2008	158,646	52,126	32.86%	43.00%	22.40%	34.29%
3rd Quarter 2008	197,138	66,457	33.71%	41.84%	22.90%	35.08%
4th Quarter 2008	209,001	68,981	33.01%	44.88%	17.56%	34.60%
1st Quarter 2009	167,546	47,863	28.57%	34.44%	10.99%	27.31%
2nd Quarter 2009	102,937	22,719	22.07%	38.77%	13.24%	22.87%
3rd Quarter 2009	66,360	14,330	21.59%	31.97%	8.08%	23.34%
Eight Quarter Total	1,190,310	365,849	30.74%			
Percent of Total Serviced	23.29%					
Percent of non-fixed rate products	48.02%					

UPB of Sub-Prime & Alt-A Loans

		30+ Days Past Due		Individual Company %		
		Number	%	High	Low	Median
4th Quarter 2007	30,731,724	9,967,284	32.43%	47.90%	23.96%	34.70%
1st Quarter 2008	29,310,124	9,517,277	32.47%	42.47%	24.41%	33.94%
2nd Quarter 2008	32,377,996	11,077,929	34.21%	46.62%	23.83%	34.85%
3rd Quarter 2008	41,922,593	14,871,422	35.47%	45.08%	24.16%	38.29%
4th Quarter 2008	46,206,549	16,357,925	35.40%	48.56%	18.14%	36.84%
1st Quarter 2009	38,384,355	11,725,243	30.55%	40.06%	11.00%	29.73%
2nd Quarter 2009	22,881,274	5,248,259	22.94%	42.27%	13.98%	23.29%
3rd Quarter 2009	14,607,466	3,127,535	21.41%	32.31%	8.34%	23.44%
Eight Quarter Total	256,422,081	81,892,874	31.94%			
Percent of Total Serviced	31.96%					
Percent of non-fixed rate products	51.55%					

DELINQUENCY & DEFAULT

Number of Prime Loans	Number	Individual Company (% of Serviced) High	Low	Median
30 to 59 days	238,446	3.97%	0.21%	1.38%
60 to 89 days	88,202	0.96%	0.66%	0.74%
90 days or over	62,073	2.06%	0.07%	0.78%
Total	388,721			
Percentage of Prime Loans Serviced	*3.78%*	*6.85%*	*0.28%*	*3.51%*
Loans from above which were modified in the last 12 months.	5,348			
Percentage of total past due	*1.38%*	*25.00%*	*0.05%*	*1.92%*
Loans which entered delinquency within 3 payments of initial rate reset	310			
Percentage of total past due	*0.08%*	*0.62%*	*0.27%*	*0.45%*
Loans where notice of default sent	9,538			
Loans where formal foreclosure proceedings started	28,433			
Total Loans in Process of Foreclosure	37,971			
Percentage of total past due	*9.77%*	*91.98%*	*0.29%*	*25.00%*
Loans where foreclosure proceeding completed (ORE)	23,944			

UPB of Prime Loans	UPB	Individual Company (% of Serviced) High	Low	Median
30 to 59 days	36,413,811	3.84%	0.16%	1.04%
60 to 89 days	14,258,173	1.04%	0.61%	0.81%
90 days or over	9,125,764	2.02%	0.06%	0.50%
Total	59,797,748			
Percentage of Prime Loans Serviced	*3.73%*	*6.89%*	*0.23%*	*3.26%*
Loans from above which were modified in the last 12 months.	813,347			
Percentage of total past due	*1.36%*	*19.84%*	*0.03%*	*1.76%*
Loans which entered delinquency within 3 payments of initial rate reset	112,468			
Percentage of total past due	*0.19%*	*1.05%*	*0.81%*	*0.93%*
Loans where notice of default sent	3,802,116			
Loans where formal foreclosure proceedings started	5,783,470			
Total Loans in Process of Foreclosure	9,585,585			
Percentage of total past due	*16.03%*	*113.05%*	*0.29%*	*20.63%*
Loans where foreclosure proceeding completed (ORE)	5,165,182			

DELINQUENCY & DEFAULT

Number of Sub-Prime & Alt-A Loans	Number	Individual Company (% of Serviced) High	Low	Median
30 to 59 days	356,850	10.05%	3.90%	6.95%
60 to 89 days	186,695	5.93%	2.06%	3.56%
90 days or over	556,578	18.27%	3.81%	16.45%
Total	1,100,123			
Percentage of Sub-Prime & Alt-A Loans Serviced	*21.53%*	*33.03%*	*12.81%*	*24.21%*
Loans from above which were modified in the last 12 months.	22,522			
Percentage of total past due	*2.05%*	*22.86%*	*0.02%*	*0.85%*
Loans which entered delinquency within 3 payments of initial rate reset	30,986			
Percentage of total past due	*2.82%*	*10.74%*	*0.68%*	*2.57%*
Loans where notice of default sent	135,024			
Loans where formal foreclosure proceedings started	140,203			
Total Loans in Process of Foreclosure	275,227			
Percentage of total past due	*25.02%*	*49.94%*	*0.65%*	*26.41%*
Loans where foreclosure proceeding completed (ORE)	102,538			

UPB of Sub-Prime & Alt-A Loans	UPB	Individual Company (% of Serviced) High	Low	Median
30 to 59 days	54,777,288	9.64%	3.79%	6.11%
60 to 89 days	30,275,397	6.13%	2.04%	3.80%
90 days or over	85,115,316	20.50%	3.04%	15.96%
Total	170,168,001			
Percentage of Sub-Prime & Alt-A Loans Serviced	*21.21%*	*35.15%*	*11.29%*	*24.94%*
Loans from above which were modified in the last 12 months.	3,562,013			
Percentage of total past due	*2.09%*	*23.14%*	*0.03%*	*0.62%*
Loans which entered delinquency within 3 payments of initial rate reset	5,378,363			
Percentage of total past due	*3.16%*	*10.66%*	*1.09%*	*3.22%*
Loans where notice of default sent	25,219,053			
Loans where formal foreclosure proceedings started	28,715,404			
Total Loans in Process of Foreclosure	53,934,457			
Percentage of total past due	*31.69%*	*99.45%*	*0.61%*	*33.37%*
Loans where foreclosure proceeding completed (ORE)	19,080,954			

LOSS MITIGATION & MODIFICATIONS

Number of Loans In-Process	Number	%	Individual Company (% allocation) High	Low	Median
Deed in lieu	3,662	1.86%	3.93%	0.23%	0.61%
Short sale	23,551	11.95%	56.17%	1.87%	12.02%
Total in process with borrower losing home	27,213	13.81%			
*Percent of past due 60 days+**	*3.26%*		*15.09%*	*0.33%*	*1.85%*
Forbearance	16,120	8.18%	41.04%	0.16%	4.33%
Repayment plan	49,704	25.22%	62.72%	3.60%	32.53%
Modification (principal reduction, interest rate &/or term of debt)	88,907	45.10%	88.94%	7.94%	14.49%
Total in process of home retention	154,731	78.50%			
*Percent of past due 60 days+**	*18.56%*		*83.51%*	*1.80%*	*14.91%*
Refinance or paid in full	2,666	1.35%	41.26%	2.95%	4.35%
Reinstatement/Account to be made current	12,503	6.34%	96.16%	6.89%	13.21%
Total in process of being resolved by borrower	15,169				
*Percent of past due 60 days+**	*1.82%*		*7.08%*	*0.31%*	*2.13%*
Total loans in loss mitigation	197,113	100.00%			
*Percent of past due 60 days+**	*23.65%*		*65.33%*	*2.25%*	*15.44%*

UPB of Loans In Process	UPB	%	Individual Company (% allocation) High	Low	Median
Deed in lieu	882,971	2.48%	5.05%	0.29%	0.78%
Short sale	5,087,706	14.30%	64.17%	2.44%	13.95%
Total in process of borrower losing home	5,970,678	16.78%			
*Percent of past due 60 days+**	*4.51%*		*21.41%*	*0.36%*	*2.23%*
Forbearance	2,596,575	7.30%	41.44%	0.11%	2.94%
Repayment plan	8,421,053	23.66%	72.01%	4.06%	28.32%
Modification (principal reduction, interest rate &/or term of debt)	16,035,804	45.06%	88.23%	4.93%	17.15%
Total in process of home retention	27,053,431	76.02%			
*Percent of past due 60 days+**	*20.44%*		*83.51%*	*1.80%*	*13.23%*
Refinance or paid in full	593,497	1.67%	12.14%	0.64%	8.09%
Reinstatement/Account made current	1,971,454	5.54%	48.71%	2.01%	7.90%
Total in process of being resolved by borrower	2,564,951	7.21%			
*Percent of past due 60 days+**	*1.94%*		*8.45%*	*0.58%*	*2.23%*
Total loans in loss mitigation	35,589,060	100.00%			
*Percent of past due 60 days+**	*26.89%*		*68.93%*	*2.81%*	*17.36%*

**Denominator adjusted to remove two companies which do not currently track modifications in process.*

LOSS MITIGATION & MODIFICATIONS

Number of Loans Closed	Number	%	Individual Company (% allocation) High	Low	Median
Deed in lieu	356	0.17%	1.40%	0.02%	0.13%
Short sale	3,456	1.68%	25.09%	0.15%	7.14%
Total closed with borrower losing home	3,812	1.86%			
Forbearance	3,129	1.52%	12.32%	0.22%	6.61%
Repayment plan	20,486	9.98%	73.87%	0.19%	24.57%
Modification (principal reduction, interest rate &/or term of debt)	19,082	9.30%	79.94%	0.39%	14.59%
Total closed solutions with home retention	42,697	20.80%			
Refinance or paid in full	8,242	4.02%	41.26%	0.67%	2.87%
Reinstatement/Account made current	150,519	73.33%	96.16%	1.15%	14.82%
Total closed with resolution by borrower	158,761	77.34%			
Total	205,270	100.00%			
Prepayment penalty waived (from any of the above)	236				

UPB of Loans Closed	UPB	%	Individual Company (% allocation) High	Low	Median
Deed in lieu	71,679	0.23%	1.98%	0.01%	0.18%
Short sale	618,663	1.98%	27.84%	0.03%	3.29%
Total closed with borrower losing home	690,343	2.21%			
Forbearance	442,260	1.42%	14.39%	0.11%	3.67%
Repayment plan	3,156,365	10.11%	82.96%	0.13%	17.96%
Modification (principal reduction, interest rate &/or term of debt)	3,340,759	10.70%	80.06%	0.54%	16.42%
Total closed solutions with home retention	6,939,384	22.22%			
Refinance or paid in full	1,761,708	5.64%	35.11%	0.53%	3.37%
Reinstatement/Account made current	21,840,334	69.93%	92.93%	1.40%	14.47%
Total closed with resolution by borrower	23,602,042	75.57%			
Total	31,231,769	100.00%			
Prepayment penalty waived (from any of the above)	14,500				

PROFILE OF MODIFICATIONS BY NUMBER OF LOANS	Number	Individual Company High	Low	Median
Time horizon for **closed** loan modifications				
Modification effective for less than life of loan (e.g. 2 years)				
Modification effective for life of loan				
Did not report				
Types of modifications **closed**				
Modification by freezing interest rate at the initial/start rate				
Modification by reducing the interest rate below the initial/start rate				
Modification by reducing the interest rate below scheduled reset rate, but above start rate				
Modification with extension of term				
Modification with reduction in principal balance				
Modification using two or more of above modifications (e.g. rate reduction and term change)				
Other modification				

This data is in process of being collected and will be available in future releases.

PROFILE OF MODIFICATIONS BY UPB OF LOANS	Number	Individual Company High	Low	Median
Time horizon for **closed** loan modifications				
Modification effective for less than life of loan (e.g. 2 years)				
Modification effective for life of loan				
Did not report				
Types of modifications **closed**				
Modification by freezing interest rate at the initial/start rate				
Modification by reducing the interest rate below the initial/start rate				
Modification by reducing the interest rate below scheduled reset rate, but above start rate				
Modification with extension of term				
Modification with reduction in principal balance				
Modification using two or more of above modifications (e.g. rate reduction and term change)				
Other modification				

Notes

For the individual company data, the Low and Average do not include companies which reported a zero value.

Number of Companies reporting a zero value in the following significant reporting items:

Delinquent sub-prime/Alt-A loans which entered delinquency within 3 payments of initial rate reset		2
In Process:	Deed in lieu	3
	Short sale	2
	Forebearance	6
	Repayment plan	2
	Modification	2
	Refinance or paid in full	8
	Reinstatement / account made current	5
Closed:	Deed in lieu	1
	Short sale	0
	Forebearance	4
	Repayment plan	1
	Modification	0
	Refinance or paid in full	1
	Reinstatement / account made current	1

APPENDIX B
CONSOLIDATED STATE REPORT

Consolidated State Report for Mortgage Servicers

Report as of the close of business: **October 31, 2007**

All dollar amounts are requesting the unpaid principal balance (UPB) and are to be in thousands (000's).

Company: ____________________

Schedule I - Operational Profile

	Part A	Number	UPB
1	Total loans serviced		
1a	Serviced loans originated and funded by an unaffiliated party		
1b	Serviced loans where originator or funder is affiliated with the servicer		
2a	Serviced loans secured by owner-occupied residence		
2b	Serviced loans for investment or second residence property		
3a	Loans which are secured by a first mortgage only		
3b	Loans which are secured by a second mortgage only		
3c	Loans which you service both the first and second mortgage		
4	**Prime loans**		
4a	Fixed rate, fully amortizing		
4b	Hybrid ARMs (2/28, 3/27s, or similar)		
4c	Adjustable rate, fully amortizing		
4d	Loans with interest only feature		
4e	Payment Option ARMs and other loans with negative amortization feature		
4f	Other		
5	**Subprime & Alt-A loans**		
5a	Fixed rate, fully amortizing		
5b	Hybrid ARMs (2/28, 3/27s, or similar)		
5c	Adjustable rate, fully amortizing		
5d	Loans with interest only feature		
5e	Payment Option ARMs and other loans with negative amortization feature		
5f	Other		

Part B

Prime Loans

6 What is the total anticipated number and amount of **prime** loans where the interest rate will have its initial reset? What number and volume of these loans are currently over 30 days past due?

	Interest Rate Reset		30+ Days Past Due	
	Number	UPB	Number	UPB
6a 4th Quarter 2007				
6b 1st Quarter 2008				
6c 2nd Quarter 2008				
6d 3rd Quarter 2008				
6e 4th Quarter 2008				
6f 1st Quarter 2009				
6g 2nd Quarter 2009				
6h 3rd Quarter 2009				

Sub-Prime & Alt-A Loans

7 What is the total anticipated number and amount of **sub-prime & Alt-A** loans where the interest rate will have its initial reset? What number and volume of these loans are currently over 30 days past due?

	Interest Rate Reset		30+ Days Past Due	
	Number	UPB	Number	UPB
7a 4th Quarter 2007				
7b 1st Quarter 2008				
7c 2nd Quarter 2008				
7d 3rd Quarter 2008				
7e 4th Quarter 2008				
7f 1st Quarter 2009				
7g 2nd Quarter 2009				
7h 3rd Quarter 2009				

Schedule II - Delinquency & Default

Part A - Prime Loans	Number	UPB
1 Loans presently past due		
1a 30 to 59 days past due		
1b 60 to 89 days past due		
1c 90 days or over past due		
2 Loans from above which were modified in the last 12 months.		
3 Loans in process of foreclosure		
3a Loans where notice of default sent		
3b Loans where formal foreclosure procedings started		
4 Loans where foreclosure preceding completed (ORE)		
5 Loans which entered delinquency within 3 payments of initial rate reset		

Part B - Subprime & Alt-A Loans	Number	UPB
6 Loans presently past due		
6a 30 to 59 days past due		
6b 60 to 89 days past due		
6c 90 days or over past due		
7 Loans from above which were modified in the last 12 months.		
8 Loans in process of foreclosure		
8a Loans where notice of default sent		
8b Loans where formal foreclosure procedings started		
9 Loans where foreclosure proceding completed (ORE)		
10 Loans which entered delinquency within 3 payments of initial rate reset		

Schedule III - Loss Mitigation and Modifications

UPB is at the time of resolution.

	Part A	Number	UPB
1	Loss Mitigation efforts **in process**		
1a	Deed in lieu		
1b	Short sale		
1c	Forbearance		
1d	Repayment plan		
1e	Refinance or paid in full		
1f	Reinstatement/Account made current		
1g	Modification (principal reduction, interest rate &/or term of debt)		

	Part B	Number	UPB
2	Loss mitigation efforts **closed**		
2a	Deed in lieu		
2b	Short sale		
2c	Forbearance		
2d	Repayment plan		
2e	Refinance or paid in full		
2f	Reinstatement/Account made current		
2g	Modification (principal reduction, interest rate &/or term of debt)		
3	Prepayment penalty waived (from any of the above)		

Part C	Number	UPB
4 Time horizon for **closed** loan modifications		
4a Modification effective for less than life of loan (e.g. 2 years)		
4b Modification effective for life of loan		
5 Types of modifications **closed**		
5a Modification by freezing interest rate at the initial/start rate		
5b Modification by reducing the interest rate below the initial/start rate		
5c Modification by reducing the interest rate below scheduled reset rate, but above start rate		
5d Modification with extension of term		
5e Modification with reduction in principal balance		
5f Modification using two or more of above modifications (e.g. rate reduction and term change)		
5g Other modification		

APPENDIX C

INSTRUCTIONS FOR CONSOLIDATED STATE REPORT

Instructions for Consolidated State Report for Mortgage Servicers

Intent
The Consolidated State Report (CSR) is intended to collect data on the status of residential mortgage portfolios, loss mitigation efforts, and foreclosures. The reports will provide important data on the status of the market. This report should also reduce the regulatory burden on the industry by providing a common reporting format which will be submitted to a single source and distributed to the pertinent state authorities.

The CSR should be completed on a consolidated basis, including all offices and subsidiaries.

Schedule I
Report all balances as point in time as of the report date.

<u>Item No.</u> <u>Caption & Instructions</u>

Part A

1 **Total loans serviced**
Report the total number and unpaid principle balance (UPB) for all first and second mortgage loans serviced by your company.
- *Items 1a & 1b should total to this item.*
- *Items 2a & 2b should total to this item*
- *Items 3a, 3b, & 3c should total to this item.*

1a **Serviced loans originated and funded by an unaffiliated party**
Report the total number and UPB for loans you service which were originated and funded by an entity not related to your company through common majority ownership, management or board of directors.

1b **Serviced loans where originator or funder is affiliated with the servicer**
Report the total number and UPB for loans you service which were originated or funded by an entity related to your company through common majority ownership, management or board of directors.

2a **Serviced loans secured by owner-occupied residence**

2b **Serviced loans for investment or second residence property**

3a **Loans which are secured by a first mortgage only**
Report the total number and UPB for loans which you only service a first mortgage.

3b **Loans which are secured by a second mortgage only**
Report the total number and UPB for loans which you only service a second mortgage.

3c **Loans which you service both the first and second mortgage**
Report the total number and UPB for loans which you service both the first and second mortgage. For the number of loans, count both loans.

4 **Prime Loans**
Report the total number and UPB for prime loans.

- *Items 4a, 4b, 4c, 4d, 4e, 4f should total to this item.*

4a **Fixed rate, fully amortizing**
Report the total number and UPB for prime loans which have a fixed rate of interest and are fully amortizing.

4b **Hybrid ARMs (2/28, 3/27 or similar)**
Report the total number and UPB for prime loans which provide low initial payments based on a fixed rate that expires after a short introductory period (two or three years), and then adjusts on a regular basis (e.g. every six months) to a variable rate plus a margin for the remaining term of the loan.

4c **Adjustable rate, fully amortizing**
Report the total number and UPB for adjustable rate, fully amortizing prime loans not meeting the definition in 4b.

4d **Loans with interest only feature**
Report the total number and UPB for prime loans which permit the payment of interest only at any point during the term.

4e **Payment Option ARMs and other loans with negative amortization feature**
Report the total number and UPB for prime loans with payment characteristics which may lead to negative amortization. Include any other loan with a negative amortization feature.

4f **Other**
Report the total number and UPB for prime loans which do not fit any of the above definitions, such as a loan with an extended amortization (e.g. a "40/30" loan with a 40 year amortization on a 30 year term (with a balloon payment at the end of the 30^{th} year)

5 **Subprime & Alt-A loans**
Subprime refers to loans to borrowers who typically have weakened credit histories that include payment delinquencies and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income (DTI) ratios, or other criteria that may encompass borrowers with incomplete credit histories. Subprime may also refer to loans with higher rates than prime loans, typically marketed to borrowers with subprime credit. Reporter should categorize loans based on commonly-accepted industry definitions.

Alt-A refers to loans to borrowers who do not qualify for prime credit or lack the required documentation to be a prime borrower or may have some of the characteristics of a sub-prime borrower.

- *Items 5a, 5b, 5c, 5d, 5e, & 5f should total to this item.*

5a-f **See respective descriptions for 4a-f.**

Part B

6 **What is the total anticipated number and amount of prime loans where the interest rate will have its initial reset? What number and volume of these loans are currently over 30 days past due?**
Report the total number and UPB of loans scheduled for an initial reset for each of the next 8 quarters. Also indicate the loans from the first two columns which are over 30 days past due.

7 **What is the total anticipated number and amount of subprime and Alt-A loans where the interest rate will have its initial reset? What number and volume of these loans are currently over 30 days past due?**
Report the total number and UPB of loans scheduled for an initial reset for each of the next 8 quarters. Also indicate the loans from the first two columns which are over 30 days past due.

Schedule II

Item No. **Caption & Instructions**

Part A – Prime Loans

1 **Loans presently past due**
Heading, *not a reporting field.*

1a **30 to 59 days past due**
Report number of loans and UPB for all prime loans where the minimum required payment has not been made for 30 to 59 days. For monthly pay loans, the borrower would be due for one payment and past due for one payment.

1b **60 to 89 days past due**
Report number of loans and UPB for all prime loans where the minimum required payment has not been made for 60 to 89 days. For monthly pay loans, the borrower would be due for one payment and past due for two payments.

1c **90 days past due or over**
Report number of loans and UPB for all prime loans where the minimum required payment has not been made for at least 90 days. For monthly pay loans, the borrower would be due for one payment and past due for three payments.

2 **Loans from above which were modified in the last 12 months**
Report number of loans and UPB for loans reported in 1a, 1b, or 1c, which have had any type of debt modification to mitigate potential loss and/or accommodate the needs of the borrower.

3 **Loans in process of foreclosure**
Report number of loans and UPB for loans reported in 1a, 1b, or 1c, which are considered to be in process of foreclosure.

- *Items 3a & 3b should total to this item.*

3a **Loans where notice of default sent**
Report number of loans and UPB for loans where during the reporting period, the borrower has been notified of default. No other action towards foreclosure has been taken.

3b **Loans where formal foreclosure proceedings started**
Report number of loans and UPB for loans where the foreclosure process has begun. (Example: Judicial filing or public notice).

4 **Loans where foreclosure preceding completed (ORE)**
Report number of loans and UPB at the time of foreclosure for mortgages which have completed foreclosure resulting in the transfer of ownership of the residence or the effective control over the property.

5 **Loans which entered delinquency within 3 payments of initial rate reset**
Report number of loans and UPB for loans reported in 1a, 1b, or 1c, which became delinquent within 3 payments of the interest rate on the loan resetting.

Part B – Subprime & Alt-A Loans

6 – 10 See respective descriptions for 1 – 5 above.

Schedule III

<u>**Item No.**</u> <u>**Caption & Instructions**</u>

Part A

1 **Loss mitigation efforts in process**
Heading, not a reporting field.
In this part, report loss mitigation efforts which are in process, but not yet complete. Report the number of loans and UPB in the category agreed to but not finalized or in the category most likely to occur.

1a **Deed in lieu**
Borrower deeds the property to the servicer to avoid foreclosure.

1b **Short sale**
Borrower sells property to a third party prior to foreclosure sale and the servicer forgives any shortage on UPB.

1c **Forbearance**
A postponement of payment on the loan.

1d **Repayment plan**
Increased payments for a specific period of time to allow the borrower to bring the loan current.

1e **Refinance or paid in full**
Borrower will secure a new loan to pay-off the existing debt or pay off in full by some other means.

1f **Reinstatement/Account made current**
Borrower will pay all past due amounts.

1g **Modification (principal reduction, interest rate &/or term of debt)**
Some or all the terms of the debt are changed to enable the borrower to service the obligation.

Part B

2 **Loss mitigation efforts closed**
Heading, not a reporting field.
In this part, report loss mitigation efforts which have been closed during the reporting period. Report the number of loans and UPB in the appropriate category following the definitions from above.

3 **Prepayment penalty waived (from any of the above)**
Report the number and amount of any prepayment penalties waived as part of any of the above actions.

Part C

4 **Time horizon for closed loan modifications**
Heading, not a reporting field.
- *The sum of 4a & 4b should equal 1g in Part B.*

4a **Modification effective for less than life of loan (e.g. 2 years)**
Report number of loans and UPB for modifications which do not cover the full term of the loan.

4b **Modification effective for life of loan**
Report number of loans and UPB for modification which are effective for the full term of the loan.

5 **Types of modifications closed**
Heading, not a reporting field.
Report the number of loans and UPB for each type of modification listed below. Note that item 5f is the reporting field for modifications with multiple characteristics.
- *The sum of 5a through 5g should equal 1g in Part B.*

5a **Modification by freezing interest rate at the initial/start rate**

5b **Modification by reducing the interest rate below the initial/start rate**

5c **Modification by reducing the interest rate below scheduled reset rate, but above start rate.**

5d **Modification with extension of term**

5e **Modification with reduction in principal balance**

5f **Modification using two or more of above modifications (e.g. rate reduction and term change)**

5g **Other modification**

Schedule IV

Report the number of loans serviced and the UPB by state.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM SHEILA C. BAIR

ANTI-UNION REGULATION

Q.1. Last year, the Department of Labor issued a regulation drastically expanding the personal financial information union officers and employees must submit to the Department The new LM–30 rule will require more than 150,000 union volunteers, employees, and their families to report the terms of mortgages, car loans, and even student loans. To determine whether they must report such interests, these individuals must ascertain (1) whether the bank providing a loan does any business with the person's union, or (2) whether the bank does 10 percent of its business with firms whose employees are in the same union. The regulation requires individuals to write to banks asking for this info, and, then, if banks won't provide such information, to contact the Department of Labor for assistance. In the meantime, individuals are required to make good faith estimates of the bank's business with their unions and unionized firms.

- Given your agency's expertise in the regulation and practices of banks, do you believe that banks are able—and willing—to inform their customers whether they do business with particular unions and how much of their "business" and "business receipts" are with particular unionized firms?
- Are banks obligated or prohibited by any federal or state law to disclose to their customers how much "business" or "business receipts" they have with particular unionized firms? Can banks simply refuse to answer these written inquiries?
- What type of administrative burden will this LM–30 rule, and the hundreds of thousands of resulting inquiries, place on banks and are banks currently prepared to respond to these inquiries?
- If banks don't provide this non-public information, is there any "information reasonably available" to the public that union officers, employees, and members could use to make good faith estimates?

A.1. The Labor-Management Reporting and Disclosure Act (LMRDA) requires public disclosures of certain financial transactions and financial interests of labor organization officers and employees (other than employees performing clerical or custodial services exclusively) and their spouses and minor children. It is our understanding that the purpose of this disclosure is, among other things, to make public any actual or potential conflict between the personal financial interests of a labor organization officer or employee and his or her obligations to the labor organization and its members.

The U.S. Department of Labor's Office of Labor-Management Standards (OLMS) issued a final rule in 2007 implementing section 202 of LMRDA. See 72 FR 36106 (July 2, 2007). The final rule revised Form LM–30, Labor Organization Officer and Employee Report and its instructions. The final rule became effective for fiscal years beginning August 16, 2007, although no reporting is due under the rule until November 16, 2008. See 72 FR. 38484 (July 13, 2007).

The FDIC understands that financial institutions are expressly relieved of any reporting responsibilities of payments or loans under section 203 of the LMRDA (see 72 FR at 36119 and 36136). Therefore, banks are not required to report customer information.

The final rule deals with Form LM–30, which requires reporting by the union officers and employees covered under the LMRDA. The final rule, as revised, does not require union officers to report most bona fide loans, interest, or dividends from financial institutions. However, the final rule may require that union officers report these types of transactions if the bank does a specified level of business with a company that employs members of the same union. The OLMS is the agency responsible for implementation and interpretation of this regulation and the FDIC defers to its determination of the exact parameters of the categories where union employees are required to report bank loans.

We know of no federal law that either requires or forbids a financial institution from informing its customers whether they deal with businesses that are unionized and what union represents the employees of those businesses, assuming that no customer information is disclosed. We see nothing in the Department of Labor rule that would require financial institutions to make those disclosures. We note, however, that banks typically build certain reporting codes into their information management systems to facilitate the creation of both regulatory related filings, such as call reports, as well as internal management reports. The basis for distinguishing and reporting based upon the type of union-related activity at issue here would not be a part of this reporting framework thereby creating issues regarding the practicality of disclosure.

The FDIC will continue to analyze the impact of the final rule on our supervised banks as we approach the November 2008 reporting deadline.

COMMERCIAL REAL ESTATE

Q.2. In December 2006, three agencies, the FRB, OCC, and FDIC, issued final guidance highlighting the risks to banks from concentrations in commercial real estate. In issuing the guidance, the regulators specifically emphasized that they were not setting any limits on banks' commercial real estate lending. Yet now we understand from the Comptroller of the Currency and the Chair of the FDIC that over a third of community banks have commercial real estate concentrations exceeding 300 percent of their capital.

- Are any community banks going to fail because of their overexposure to commercial real estate, including commercial real estate mortgage backed securities?
- Was it the correct policy not to set concentration limits in the guidance?
- What are examiners doing when they find these levels of concentrations?
- What off-balance sheet vehicles are banks using to invest in commercial real estate?

- Are the regulators approving these kinds of transactions?

A.2. As noted in the FDIC's testimony, weakness in the housing market will affect institutions with significant exposures to commercial real estate (CRE) loans—particularly construction and development loans. Given deteriorating conditions and excess supply in certain housing markets such as Florida, California, Arizona, and Nevada, construction and development lending could cause some community banks to fail in 2008 and 2009. While we do not currently anticipate a sharp increase in failures, the protracted nature of real estate downturns may challenge the earnings capacity and capital levels of institutions with concentrated exposure to construction and development projects. At present, the various sectors of the commercial real estate market including apartments, office buildings, retail, and industrial have performed adequately and are not expected to cause bank failures in the near term. However, if we experience a significant economic downturn, commercial real estate mortgages could cause losses for insured institutions that may lead to failures.

The December 2006 interagency commercial real estate guidance provided an appropriate, timely message to the industry regarding risk management standards, loan concentration reporting thresholds, and capital adequacy. Bankers are very aware of the monitoring thresholds stated in the guidance, and the document positively influenced commercial real estate credit risk management. The establishment of specific concentration limits would have been prescriptive and could have caused an unintentional aversion to commercial real estate lending. A limit on commercial real estate lending would have had negative consequences for the market and exacerbated the credit availability challenges in the current environment.

In March 2008, the FDIC issued a Financial Institution Letter (FIL) to all banks under its supervision re-emphasizing the importance of strong capital and loan loss allowance levels, and robust credit risk-management practices for state nonmember institutions with significant concentrations of CRE loans, and construction and development loans. The FIL recommends that state nonmember banks with significant CRE loan concentrations increase or maintain strong capital levels, ensure that loan loss allowances are appropriately strong, manage portfolios closely, maintain updated financial and analytical information, and bolster loan workout infrastructures.

FDIC examinations of institutions with significant commercial real estate loan concentrations, as defined by the 2006 interagency guidance, focus on each bank's credit risk management program, internal measurement and reporting on concentrations, examiner review of individual credit relationships, and an assessment of capital and loan loss reserve adequacy. Examiners undertake a thorough review of commercial real estate lending policies and underwriting processes and gain an understanding of management's risk-taking philosophy. Departures from prudent policies, underwriting, risk selection, or concentration management may be subject to examiner criticism. Significant deficiencies related to commercial real estate loan concentrations sometimes result in formal or informal enforcement actions.

From an investment standpoint, banks are generally limited in their acquisitions of commercial real estate to property that will only be used as bank premises. There are certain exceptions to this limitation that are permitted under the investment authorities for national banks. Otherwise, a bank must apply to the FDIC (under section 24 of the Federal Deposit Insurance Act (FDI Act)) for permission to invest in commercial real estate on the balance Sheet. An off-balance sheet investment in commercial real estate would be unusual.

From a lending standpoint, commercial real estate loans or interests therein are typically originated and held directly by the bank, or a bank subsidiary, on the bank's balance sheet. Off-balance sheet holdings of interests in commercial real estate loans are generally rare and limited to the largest institutions: that securitize such loans. In a commercial mortgage backed security, a bank that securitizes commercial real estate loans sells the loans (on a non-recourse basis) to a trust that then distributes these credits on to third party investors. Depending on the governing securitization documents, the bank that originated a commercial real estate loan could be liable for the loan's performance under certain circumstances, as well as be required to prudently carry out the duties of special servicer if the bank retained servicing. It is theoretically possible that sold loans could be put-back to the originating bank if the governing documents or courts permitted such recourse. Such situations are relatively rare. The bank regulators do not approve securitization transactions, which are accounted for as loan sales. Large institutions that trade credit derivatives also could have a commercial real estate credit exposure off-balance sheet. However, most derivative positions are now booked on the balance sheet according to accounting rules.

BASEL II

There was extensive conversation on what would have been the capital status of banks going into this crisis period had Basel II capital standards been in effect. Fed Vice-Chairman Kohn said that if, "we had the same safeguards in place, and if we started implementing in 2004 with the same safeguards that are in place in 2008 and 2009, I do think on balance we would have been better off." Mr. Gronstal answered differently, stating: "I think the answer to your second question is that we probably would have had lower dollar amounts of capital per asset, and that makes it more challenging to deal with issues when times get rough."

Q.3.a. Can you explain in writing, whether you believe that banks would have had more or less capital in place for this current down turn had Basel II been implemented during the time frame that Vice-Chairman Kohn mentioned in his response? Can you also explain why you believe that to be the case, citing any empirical data on both the effects of Basel II on capital requirements and what we have experienced during this economic crisis, as it relates to assets?

A.3.a. I believe that banks would have had less capital in place for the current downturn had Basel II been implemented during 2004. The U.S. Quantitative Impact Study-4 (QIS-4) estimated the advanced approaches would reduce capital requirements for mortgages and home equity loans by 73 percent to 80 percent. In addition, for certain securitization exposures, the advanced approaches slash the capital requirements significantly compared to the current rules and would have encouraged banks to hold more highly rated collateralized debt obligations (CDOs) and other complex securities that have caused losses in the tens of billions of dollars for large financial institutions. For many of these exposures, the capital requirements are reduced by almost two thirds—from 1.6 percent to 0.56 percent of face value.

There is every reason to assume that banking organizations would have reduced their actual regulatory capital holdings in an amount commensurate with this reduction in minimum capital requirements. A case in point is given by Northern Rock, the British bank with assets of about $200 billion that was recently nationalized. We understand that the British regulators provided banks that were interested, and deemed ready, the opportunity to implement certain aspects of the advanced approaches in 2007. In reference to the 44 percent reduction in risk-weighted assets Northern Rock reported using the advanced methodologies for its retail portfolio, its CEO wrote:

> We are pleased to have achieved approval for use of our Basle II rating systems. This means that the benefits of Basle II enable us to increase our 2007 interim dividend by 30 percent. Going forward our dividend payout rate increases to 50 percent of underlying EPS from around 40 percent. Future capital planning, including the reduction of capital hungry assets, will allow us to return capital to shareholders through a share buyback programme. The medium term outlook for the Company is very positive.
> —CEO Adam Applegarth, Northern Rock Interim Results, June 30, 2007.

Q.3.b. During the discussion of Basel II, Comptroller Dugan told the Committee: "The irony of this whole situation is that the very high—most highly rated best securities, the ones that were thought to be least likely to default was where all the—a huge share of the losses have been concentrated." Given Basel II's reliance on ratings of securities, does this observation give you reason for concern over the current Basel II structure? If so, what do you recommend be done; if not, why not?

A.3.b. The unprecedented downgrades and massive losses incurred by banks on AAA rated structured securities such as CDOs and asset backed securities (ABS) are a prime example why models cannot be relied upon to set capital requirements that are meant to protect and preserve the solvency of our nation's financial institutions. The models used to assign a AAA rating to these securities were no more than estimates that attempted to apply past performance to predict future events. However, the assumptions used to assign these ratings did not capture the true stresses that accompanied the current credit market crisis.

In some cases, the models that failed the ratings agencies are similar to the models used by banks to set capital requirements on a wide range of exposures under Basel II. What is even more troubling is that these AAA rated structured securities that played a prominent role in contributing to the hundreds of billions of dollars in write-downs have been awarded sizable capital reductions under Basel II. Under the new rules, the capital requirement for these securities is a mere fraction of the losses incurred to date with banks only required to set aside 56 cents for every $100 in exposures. Under the existing U.S. rules that apply to all but the largest banks, the capital requirement for these same securities is $1.60 for every $100 in exposures.

The Basel Committee has acknowledged some of the deficiencies with the Basel II framework, especially as it relates to the complex structured securities discussed above. However, the lesson to be learned from the credit market turmoil should be applied well beyond CDOs. The major issue is that the models did not perform adequately, and Basel II is heavily reliant upon models for determining capital requirements. Fixing the risk weights on complex securities is a good start but that alone will not address the larger scale problems with Basel II.

In this respect, U.S. bank regulation benefits considerably from our statutory framework of Prompt Corrective Action (PCA), including regulatory constraints on bank balance sheet leverage. The PCA framework provides abase of capital to absorb losses in the event the risk-based models are overly optimistic and helps limit the exposure of governmental safety nets during difficult times. In addition, a leverage ratio, or similar clear-cut supplementary capital requirement to complement the risk-based approaches and constrain excessive leverage, would greatly benefit the effectiveness of global financial regulation.

As you know, the regulation issued by U.S. banking, agencies does not allow any bank to exit its risk-based capital floors until the completion of an interagency study on the impact of the new advanced approaches. This interagency study will be extremely important in that it provides a structured process for the agencies to evaluate potential weaknesses of these new rules and decide how to address them.

TOO BIG TO FAIL

Q.4. I am concerned about the potential ramifications of the failure of a very large institution. Is your agency prepared today to handle the failure of a large systemically significant insured financial institution? What steps are you taking to prepare for this contingency?

A.4. The FDIC has been taking a number of steps to ensure our ability to handle the failure of a large financial institution. For example, several years ago we started a project to facilitate the claims process at the very largest and most complex banks. This includes a process to hold some fraction of large deposit accounts in the event of failure, to have the ability to produce depositor data for the FDIC in a standard format, and to be able to automatically debit uninsured deposit accounts to share losses with the FDIC. In January 2008 we issued a notice of proposed rulemaking to solicit comments in consideration of a final rule. We hope to issue a final rule as early as mid-year.

In recent months, the FDIC also has begun hiring additional staff to ensure that we are prepared for any type of increased bank resolution activity: This hiring is a mix of temporary appointments that can lapse once any problems are addressed, retirees who can provide "experience from past failures, and new skill sets (such as capital markets expertise) that are relevant to resolving troubled institutions in today's market.

Finally, the FDIC has been working with other regulators to improve information sharing processes and procedures regarding troubled financial institutions to ensure that all of us have the information we need to fulfill our roles in the event-of bank failures. Our participation as part of the President's Working Group is a welcome improvement to this communication.

DATA ON LOAN MODIFICATION

Q.5. Please provide comprehensive data on mortgage delinquencies, foreclosures, repayment plans and modifications for the mortgages being serviced by the institutions you regulate for the past 12 months. Please provide this information by the following loan categories: subprime, Alt-A, and prime. Please describe the types of repayment plans and modifications that servicers are employing and the numbers of loans in each category.

A.5. Because most FDIC-supervised institutions do not service securitized loan pools, we do not collect data for the categories requested. Nevertheless, the available data so far seems to indicate that too many modifications involve repayment plans that only act to defer problems rather than create long-term sustainable mortgages.

Publicly available data from the HOPE NOW Alliance estimate that, on an industry-wide basis, mortgage servicers provided loan workout plans for over 2 million loans during 2007 and first quarter 2008. Subprime loans account for the majority of these workouts, at 60 percent of the total. Prime loans account for the remainder; there is no breakout for Alt-A loans. Loan workouts have numbered nearly three times more than foreclosure sales.[1]

The following tables summarize borrower foreclosure sales and loan workout plans on an industry-wide basis from first quarter 2007 through first quarter 2008.

FORECLOSURE SALES

[Thousands of residential loans]

	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	Total
Foreclosure Sales:						
Total	110	117	135	151	205	718
Prime	48	49	54	60	84	295
Subprime	62	89	82	92	121	426

BORROWER LOAN WORKOUT PLANS

[Thousands of residential loans]

	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	Total
Borrower Workout Plans: *						
Total	324	340	399	475	503	2,041
Prime	135	132	150	173	206	796
Subprime	189	208	248	301	296	1,242

[1] HOPE NOW mortgage servicers cover almost two-thirds of the mortgage industry for both prime and subprime loans. All data are from their release of quarterly 2007 and 2008 data at: *http://www.csbs.org/Content/NavigationMenu/Home/StateForeclosureApril2008.pdf*.

BORROWER LOAN WORKOUT PLANS—Continued

[Thousands of residential loans]

	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	Total
Formal Repayment Plans Initiated:						
Total	271	275	323	333	323	1,525
Prime	111	102	120	136	159	628
Subprime	160	173	203	197	165	898
Loan Modifications Completed:						
Total	54	65	76	141	179	515
Prime	24	30	30	37	48	169
Subprime	29	35	46	104	132	346

* Workout plans are the sum of formal repayment plans initiated and loan modifications completed.
Note: Numbers may not add due to rounding.
Source: HOPE NOW Alliance.

According to the Mortgage Bankers Association's National Delinquency Survey, the performance of prime mortgages deteriorated from the prior quarter. In fourth quarter 2007, 5.82 percent of all mortgage loans were 30 days or more past due. The percentage of all mortgages that were seriously delinquent (loans that are 90 days or more past due or in the process of foreclosure) was 3.62 percent The survey reported that 3.24 percent of conventional prime mortgages were 30 days or more past due. The percentage of prime mortgages that were seriously delinquent was 1.67 percent.

Delinquency and foreclosure rates for subprime mortgages continue to rise. In fourth quarter 2007, 17.31 percent of subprime mortgages were 30 days or more past due, while 14.44 percent of these mortgages were seriously delinquent. Subprime ARMs continue to experience the. greatest stress. In fourth quarter 2007, 20.02 percent of subprime ARMs were 30 days or more past due, while 20.43 percent of these mortgages were seriously delinquent. The Mortgage Bankers Association does not provide a breakout for Alt-A loans.

At FDIC-insured banks and thrifts, the ratio of noncurrent (90 days or more past due or on nonaccrual) 1–4 family residential mortgage loans increased to 2.06 percent in fourth quarter 2007. This level is double that of one year ago, when the ratio was 1.05 percent, and is the highest noncurrent level since at least 1991.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM SHEILA C. BAIR

Q.1. How accurate and predictive were the risk models used by banks and ratings agencies in identifying the risks now unfolding in the current market turmoil?

A.1. Banks, ratings agencies, and regulators vastly underestimated the risks in mortgage markets and in complex highly-rated securities. Even today, it is difficult to quantify these risks. Models did not forecast the significant deterioration in the credit markets, nor did they predict the fact that adverse events would be highly correlated, making a bad situation worse. The models failed to capture what is referred to as "tail risk," the risk of loss associated with extreme events. Yet it is those same events that can threaten the solvency of our financial system. The models that will be used by banks in determining capital requirements under the advanced approaches are based largely on the same models that are used by the ratings agencies that failed to capture the massive losses in the credit markets.

Q.2.a. If the advanced approaches could have been put in effect immediately after they were published by the Basel Committee in June, 2004: Would banks using these approaches have been required to hold more capital against their mortgage portfolios?

A.2.a. No. The U.S. Quantitative Impact Study–4 (QIS–4) estimated the advanced approaches would reduce median capital requirements for mortgages and home equity loans by 73 percent and 80 percent respectively. If banks had been allowed to implement such reductions in capital requirements for their mortgages, they would have been much more vulnerable going into the current problems.

The QIS–4 result likely reflects that the formula underlying the advanced approach mortgage capital requirements was developed during a period of benign credit conditions and historically robust house price appreciation. Banks calculate their mortgage capital requirements in the advanced approaches by inputting certain key parameters (probability of default (PD), loss given default (LGD) and exposure at default (EAD)) for the various pools of mortgages they hold, reflective of their own historical credit loss experience for similar mortgages, into a function prescribed in regulation.

Some have argued that the advanced approaches would require more capital than QIS–4 estimated. No one has disputed, to our knowledge, that any reasonable approach to estimating historical mortgage credit losses over a long period of time prior to the current crisis would result in PI, LGD and EAD values that, if input into the advanced formula, would result in extremely large reductions in mortgage capital requirements compared to Basel I levels. The problem with this result, as we have seen in the current environment, is that perceptions of minimal risk based on historical statistics can induce lenders to change underwriting standards and develop new products that may sharply elevate losses compared to historical norms.

Q.2.b. Would the advanced approaches have generated sufficient capital requirements to account for the risks present in highly rated CDOs and other complex securities that have caused losses in the tens of billions for large financial institutions?

A.2.b. No. The advanced approaches reduce the capital requirements significantly compared to the current rules and could well have encouraged banks to hold more AAA-rated CDOs. For many of these exposures, the capital requirements are reduced by almost two thirds from 1.6 percent to 0.56 percent of face value, or equivalently from a 20 percent risk weight down to a 7 percent risk weight. This result is not unique to CDOs. Under the advanced approaches most AAA-rated securities are expected to receive this same reduction in capital requirements. The new framework thus risks giving banks an incentive to rely on ratings to an even greater extent than before.

The Basel Committee recently announced that it will revisit the 7 percent risk weight for certain types of resecuritized assets such as CDOs. While worthwhile, it is noted that this effort should be considered a response to current events rather than an aspect of the advanced approaches that would have forestalled or mitigated the development of those events.

Q.2.c. Would the advanced approaches have provided a regulatory capital incentive for banks to avoid the use of off-balance sheet conduit financing arrangements such as SIVs?

A.2.c. No. The advanced approaches require no capital for bank SIV structures in which the bank has no legal commitment to support such entities. In recent months we have seen banks around the world take large volumes of assets back on their balance sheets—assets that were held in SIVs or other conduits. In many cases it appears there was no contractual legal obligation for banks to do this and, consequently, the banks were not required to hold capital against these exposures. There is nothing in Basel II that would require banks to hold capital before the fact against off-balance sheet entities in cases where the bank has no contractual legal obligation to provide support. After the bank has provided support, supervisors can determine the bank has *de facto* risk exposure and can require capital, yet even this is not a hard and fast requirement.

The advanced approaches treatment of off-balance sheet entities where the bank does have a legal obligation to provide support also is of interest. Historically, Basel I provided a loophole where banks were required to hold capital against off-balance sheet liquidity facilities with maturities of one year or more but were not' required to hold capital where the liquidity facilities had maturities of less than one year. Not surprisingly, many banks began using 364-day maturity renewable liquidity facilities to avoid the capital requirement. The U.S. banking agencies closed this loophole in 2004. Outside the U.S., however, the loophole remained open, and Basel II does have the advantage in those countries of closing that loophole.

With respect to the amount of capital required for off-balance sheet exposures, extreme caution is warranted in asserting Basel II is an improvement. FDIC calculations based on the QIS–4, for example, showed that the total amount of capital required for off-balance sheet exposures was considerably less under the advanced approaches than under the current rules. This reflects the greater flexibility banks have in the advanced approaches both to model the amount of their exposure and to use their own risk estimates to determine the appropriate risk weight for the exposure.

Q.2.d. Would the advanced approaches have provided a regulatory capital incentive for banks to avoid excessive dependence on bond insurers?

A.2.d. No. The advanced approaches give significant new capital relief for banks entering into credit default swaps with bond insurers. Under the advanced approaches, banks would be able to gain significant capital benefits under the assumption that they can transfer significant amounts of their credit risk to insurance companies and other parties through complex structures such as credit derivatives. The new rules also provide capital benefits that assume that there is very little correlation between the creditworthiness of the insurer and that of the banks' exposure. During the recent credit market turmoil, we have witnessed a significant deterioration in the creditworthiness of many of the financial guarantors that banks rely upon to cover losses. Further, the fortunes of both the banks' exposures and that of the insurer appear to be tied much more closely than we had anticipated. Under these conditions, the capital requirements might not fully be capturing that connection and might not fully reflect this risk.

Q.2.e. Would the advanced approaches have required banks to hold more capital against commercial real estate?

A.2.e. No. The QIS–4 estimated banks would have to hold about half the capital (median decline) against their commercial real estate (CRE) exposures. As described above for mortgages, banks calculate their CRE capital requirements by inputting their own estimates of the PDs, LGDs and EADs applicable to their CRE exposures into supervisory formulas. The capital requirements generated by such formulas depend upon these inputs, which in turn are heavily influenced by historical credit loss experience.

The roughly 50 percent median reduction in capital requirements for CRE estimated by the QIS–4 was surprising to many observers because CRE is historically a relatively risky bank asset class. However, a large reduction in CRE capital requirements is exactly what the advanced approaches can be expected to deliver during a period of strong economic conditions. If such a reduction in CRE capital requirements had been put into effect in the years leading up to the current crisis, banks would be much less well positioned to deal with credit losses.

Q.2.f. Would the advanced approaches have required banks to hold more capital against leveraged commercial loans?

A.2.f. Capital for C&I loans, in general, declined (median) in the QIS–4 by about a third. In addition, please see our answers to questions 2a and 2e.

Q.2.g. Would the advanced approaches have required more capital overall, so that large banks would have been better capitalized going into the current market turmoil?

A.2.g. No. The median decline in risk-based capital requirements reported by the 26 U.S. banks in QIS–4 was 26 percent, with a number of banks reporting declines of 30 percent to 50 percent. Significant reductions in capital requirements were reported across all major loan categories with the exception of credit cards. Significant reductions in capital requirements also were reported for securitization exposures. The 26 percent median reduction in capital requirements includes the effect of Basel II's new capital charge for operational risk, indicating that the additional capital reported for the new charge was swamped by the large reductions in capital requirements for credit risk. The 26 percent median reduction in capital requirements did not include the effect of a 1.06 "scaling factor" applied to the credit risk charge under the final rule that would dampen these reported capital reductions but not qualitatively change the overall result of large reductions in capital requirements.

To reiterate points made in responses to earlier questions, had large U.S. banks been permitted during the years leading up to the current crisis to implement reductions in capital requirements of the magnitudes suggested by the advanced approaches, the banking system would be much more vulnerable today.

Q.3. Would banks reduce their actual capital in response to the advanced approaches?

A.3. Yes. We believe the evidence suggests banks would use the leeway available to them under the advanced approaches to reduce their capital.

A comparison of the capital levels of large European banks versus large U.S. banks provides strong evidence that banks will reduce their capital levels when given a regulatory opportunity to do so. Ratios of tier 1 capital to balance sheet assets of large European banks typically are in the range of two percent to four percent, with the very largest institutions typically being closer to two percent. These banks have no direct regulatory constraint on financial leverage. U.S. banks, in contrast, do face leverage ratio requirements under the Prompt Corrective Action regulations, and the insured banks hold tier 1 capital well in excess of five percent of balance sheet assets as a direct result of these regulations.

Capital regulation matters a great deal for the capital banks actually hold. Throughout the development of Basel II, most banks involved in the discussions understood Basel II and especially the advanced approaches to be an opportunity to lower their capital requirements. This accounts for the almost universal endorsement by large banks of the core elements of Basel II, which was tempered when constraints on capital reductions became part of the U.S. discussions.

A case in point is given by Northern Rock, the British bank with assets of about $200 billion that was recently nationalized. We understand that the British regulators provided banks that were interested, and deemed ready, the opportunity to implement certain aspects of the advanced approaches in 2007. In reference to the 44 percent reduction in risk-weighted assets Northern Rock reported using the advanced methodologies for its retail portfolio, its CEO wrote:

> We are pleased to have achieved approval for use of our Basle II rating systems. This means that the benefits of Basle II enable us to increase our 2007 interim dividend by 30 percent. Going forward our dividend payout rate increases to 50 percent of underlying EPS from around 40 percent. Future capital planning, including the reduction of capital hungry assets, will allow us to return capital to shareholders through a share buyback programme. The medium term outlook for the Company is very positive.—CEO Adam Applegarth, Northern Rock Interim Results, June 30, 2007.

Q.4. Would the advanced approach require banks to raise capital substantially during a downturn?

A.4. The advanced approaches capital requirements could rise sharply during a downturn compared to pre-downturn levels. This could cause banks to be either out of regulatory compliance or forced to raise substantial capital when they are least able to do so.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM SHEILA C. BAIR

Q.1. Although not all the items that you suggested were included in this package and there might need to be a few tweaks, are there any items in this package that your agency cannot support or are these all items that would increase regulatory efficiency without. compromising safety and soundness and important consumer protections?

A.1. With one exception discussed below, the package of regulatory burden relief amendments generally does not raise significant safety and soundness or consumer protection concerns for the FDIC. In addition, our staff has identified a few technical issues that may merit further staff-to-staff discussion. FDIC staff will contact your staff to address issues regarding the bill's provisions that would eliminate the current statutory requirement for notice to the FDIC of certain public welfare investments by banks. We also would like to discuss some technical drafting suggestions to avoid unintended consequences from the bill's provisions regarding the applicability of section 404 of the Sarbanes-Oxley Act to small banks.

The one provision the FDIC does not support is the proposal to raise the small institutions exception threshold for annual examinations from less than $500 million to less than $1 billion in total assets. Current law requires the banking agencies to conduct a full-scale, on-site examination of the depository institutions under their jurisdiction at least every 12 months. There is an exception for certain small institutions (i.e., institutions with total assets of less than $500 million) that requires examinations of these qualifying smaller institutions at least every 18 months. At this time, the FDIC would not support raising the threshold and extending the examination cycle for institutions of $500 million or more. The threshold was only raised to $500 million in late 2006 and it would be useful to have more experience with this change, especially in the current challenging economic times, before considering expanding the exception.

Q.2. Since all of these items have been vetted and reviewed in past hearings before the Banking Committee, is there any reason to not move quickly forward with a package along these lines?

A.2. With the exception of the issues regarding increasing the exception threshold for annual exams for small institutions, it is likely that remaining issues regarding the regulatory relief proposal could be resolved fairly easily. In addition, we would recommend consideration of items from the legislative package provided to you by the FDIC in response to your previous request that should help reduce regulatory burden and improve regulatory efficiency.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM JOHN C. DUGAN

ANTI-UNION REGULATION

Q.1. Last year, the Department of Labor issued a regulation drastically expanding the personal financial information union officers and employees must submit to the Department. The new LM–30 rule will require more than 150,000 union volunteers, employees, and their families to report the terms of mortgages, car loans, and even student loans. To determine whether they must report such interests, these individuals must ascertain (1) whether the bank providing a loan does any business with the person's union, or (2) whether the bank does 10 percent of its business with firms whose employees are in the same union. The regulation requires individuals to write to banks asking for this info, and, then, if banks won't provide such information, to contact the Department of Labor for assistance. In the meantime, individuals are required to make good faith estimates of the bank's business with their unions and unionized firms.

- Given your agency's expertise in the regulation and practices of banks, do you believe that banks are able—and willing—to inform their customers whether they do business with particular unions and how much of their "business" and "business receipts" are with particular unionized firms?
- Are banks obligated or prohibited by any federal or state law to disclose to their customers how much "business" or "business receipts" they have with particular unionized firms? Can banks simply refuse to answer these written inquiries?
- What type of administrative burden will this LM–30 rule, and the hundreds of thousands of resulting inquiries, place on banks and are banks currently prepared to respond to these inquiries?
- If banks don't provide this non-public information, is there any "information reasonably available" to the public that union officers, employees, and members could use to make good faith estimates?

A.1. On July 2, 2007, the Department of Labor's Office of Labor-Management Standards (OLMS) published a final rule revising Form LM–30 Labor Organization Officer and Employee Report and its instructions (Final Rule).[2] The Final Rule is effective for fiscal years beginning August 16, 2007, and the first reports on the revised LM–30 must be made 90 days after the end of the fiscal year. Thus, no reporting is due until November 2008.

Form LM–30 is used by officers and employees of labor organizations subject to the Labor-Management Reporting and Disclosure Act of 1959 (LMRDA). The LMRDA requires public disclosure of certain financial interests held, income received, and transactions engaged in by labor organization officers and employees and their spouses and minor children. Financial institutions do not have to report payments or loans under section 203 of the LMRDA.[3] Therefore, national banks are not required to report customer information under the LMRDA.

Under the final rule, union officers are not required to report most loans, interest, or dividends from financial institutions. However, the following loans must be reported:

- A loan to a union official from a financial institution that is an employer whose employees the official's labor organization represents or is actively seeking to represent.

[2] 72 Fed. Reg. 36106 (July 2, 2007).
[3] Id. at 36119.

- A loan to a union official from a financial institution that is a trust in which the official's labor organization is interested.[4]
- A loan to a union official from a financial institution that is: (1) a business that buys from, sells, or otherwise deals with the official's labor organization; (2) a business that buys from, sells, or otherwise deals with a trust in which the official's labor organization is interested; or (3) a business a substantial part of which (10% or more) consists of buying from, selling to, or otherwise dealing with an employer whose employees the official's labor organization represents or is actively seeking to represent.

In January of this year, the AFL–CIO filed a lawsuit against the Labor Department challenging the Final Rule under the Administrative Procedure Act. The lawsuit is pending in the U.S. District Court for the District of Columbia (Case 1:08–cv–00069). The lawsuit challenges five aspects of the Final Rule's modifications to the LM–30, one of which is the treatment of loans from financial institutions. The AFL–CIO claims that the LMRDA does not support the requirement that loans be reported on the LM–30 if the institution deals with the borrower's labor organization or a trust in which that organization is interested or does a substantial part of its business with employers whose employees the labor organization represents or seeks to represent. The AFL–CIO has filed a motion for summary judgment, and the parties have completed briefing on that motion.

Given that these issues are in active litigation in which we are not involved, we are simply not in a position to comment on any of the requirements for reporting of bank loans on the LM–30.

[4] A "trust in which a labor organization is interested" is a trust or other fund or organization (1) that was created or established by a labor organization, or one or more of the trustees or one or more members of the governing body is selected or appointed by a labor organization, and (2) a primary purpose of which is to provide benefits for the members of such labor organization or their beneficiaries.

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NEWS RELEASE

Comptroller of the Currency
Administrator of National Banks

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Comptroller Dugan Unveils New OCC Mortgage Metrics Report

NEW YORK — In a speech to the American Securitization Forum in New York, Comptroller of the Currency John C. Dugan unveiled a new Mortgage Metrics Report compiled by the Office of the Comptroller of the Currency (OCC) and focused on delinquencies, loss mitigation actions, and foreclosures in mortgages serviced by national banks.

Recognizing the need for more granular data to assess the state of troubled mortgage markets, in February the OCC began requiring the nine largest national bank mortgage servicers to submit comprehensive mortgage data on a monthly basis. The report analyzes data submitted on each of the more than 23 million loans held or serviced by these nine banks from October 2007 through March 2008. The $3.8 trillion portfolio represents 90 percent of mortgages held by national banks and about 40 percent of mortgages overall. The participating national banks are Bank of America, Citibank, First Horizon, HSBC, JPMorgan Chase, National City, USBank, Wachovia, and Wells Fargo.

In creating the new report, "the OCC seized the opportunity to improve the way mortgage performance is measured, producing better information for supervision of our banks, and better information for policymakers, other regulators, market participants, and the public," the Comptroller said.

Findings highlighted by Comptroller Dugan included:

- The overall mortgage servicing portfolio of the nine banks reflects credit quality that is relatively satisfactory and relatively stable. The number of current and performing loans remained at about 94 percent over the entire six-month period.
- While Subprime mortgages constituted less than 9 percent of the total portfolio, they sustained twice as many delinquencies as either Prime or Alt-A mortgages.
- Among loss mitigation actions, payment plans predominated, outnumbering loan modifications in March 2008 by more than four to one, but loan modifications increased at a much faster rate during the period.
- Subprime mortgages accounted for 43 percent of all loss mitigation actions at the end of March, while making up less than 9 percent of the portfolio. Loss mitigation actions exceeded newly initiated foreclosures among Subprime borrowers by nearly 2 to 1.

- As in other studies, foreclosures in process are clearly on the rise – climbing from 0.9 percent of the portfolio to 1.23 percent – but the number of new foreclosures varied considerably month to month and was down substantially in March from a high in January.
- Seriously delinquent Subprime loans had fewer new foreclosure starts than similarly delinquent Prime or Alt-A mortgages, perhaps reflecting the national emphasis on developing alternatives and assistance programs for this class of borrowers.

The new OCC report improves upon other reports on the mortgage industry in three ways. First, its metrics are comprehensive, covering servicers and holders of mortgages and all mortgages, not just Subprime. Second, the report is based on loan-level data rather than surveys that report aggregate or summary information submitted quarterly or less frequently. The loan-level data provides greater detail and reliability over time. Third, the agency established standardized definitions and data elements to ensure information is reported consistently from bank to bank and from loan to loan.

"We are hopeful that the standard definitions and methodology used in this report will be applied more broadly across the US mortgage market," the Comptroller said. "The more we can use standardized metrics across the board, the better we can measure, monitor, and manage mortgage risk."

Although this initial data set was provided on a "best-efforts" basis and includes some "noise" in the data, the OCC is working with the banks to validate the accuracy and fill gaps in the data gathered. The Comptroller also noted that some of the conclusions in the report may seem different than conclusions reported elsewhere, but with good reason. "The data in this report is more precise since it is on an individual loan basis; the population of mortgages held and serviced by these banks has some characteristics different than the overall population of mortgages; and the standard data elements and definitions in the report will also lead to differences in reported results."

The complete report is available on the OCC's Web site at www.occ.gov.

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NEW COMPREHENSIVE OCC REPORT ON MORTGAGE PERFORMANCE

REMARKS BY JOHN C. DUGAN, COMPTROLLER OF THE CURRENCY, BEFORE THE AMERICAN SECURITIZATION FORUM, JUNE 11, 2008

It's a pleasure to be here with all of you this morning. The American Securitization Forum brings together key participants in securitization markets, which have financed an extraordinary amount of economic activity over the last several decades. Many of the roughly 1,700 national banks that the OCC supervises play outsized roles in these markets, as loan originators, servicers, structurers, trustees, dealers, distributors, and investors—and that's not an exhaustive list. They have been deeply involved in the growth of securitization, and nowhere has that been more apparent than in the phenomenal growth of residential mortgage securitization markets.

For example, in 2007, national banks originated about 45 percent of all home mortgages in the United States. They also act as servicers for about 44 percent of all U.S. mortgages. About 90 percent of the mortgages they service are held by third parties via securitization by Fannie Mae, Freddie Mac, and other financial institutions. National banks also hold a substantial amount of both mortgage securities and first mortgages on their balance sheets, which together total over $1.7 trillion. In short, over the last 20 years, national banks have become much more centrally involved in the mortgage business, and as a result, the OCC has become much more centrally involved in the supervision of these activities.

Needless to say, against this backdrop, the mortgage market disruptions of the last year have been exceptionally challenging for both national banks and their supervisor. Fortunately, the banks we supervise were well capitalized going into this turmoil. In addition, their diversified businesses and strong deposit franchises have been real sources of strength, and they have benefited from the fact that they hold and service a disproportionately small share of subprime mortgages—only about 10 percent. Still, several national banks have sustained exceptionally large losses from mortgage-related assets—which they have offset by successfully raising capital—and mortgage exposure and mortgage involvement remain substantial across the national banking system.

THE NEED FOR BETTER METRICS

As mortgage delinquencies and foreclosures have climbed, the OCC has intensified our already heavy focus on mortgage supervision. In this context, we began to realize that the substantial amount of mortgage data we had previously collected from our banks was not giving us a sufficiently granular look at declining mortgage performance. At the same time, given their leading role as mortgage servicers, national banks began to receive numerous and differing requests for data about mortgage performance and mortgage modifications from organizations around the country, including members of Congress, news organizations, and state and local governments.

We also came to realize that there were some significant limitations with the mortgage performance data reported by other organizations and trade associations. These other sources often used differing definitions of "prime," "subprime," "Alt-A," and "delinquency." This lack of standardized definitions made comparisons difficult across different studies. The same was true with respect to the different ways in which both institutions and data collectors described "mortgage mitigations," with some counting any contact with a borrower about payment reduction or relief as a mitigation in process, while others did not count mitigation efforts until a particular mitigation plan had been formally implemented. And virtually none of the data had been subjected to a rigorous process to check for consistency and completeness—they were typically responses to surveys that produced aggregate, unverified results from individual firms. That lack of loan-level validation raised real questions about the precision of the data, at least for our supervisory purposes.

In this context, the OCC realized we had a real opportunity to improve the way that mortgage performance could be measured, producing better information for our particular supervisory purposes, and better information for policymakers, other regulators, market participants, and the public at large. That is, we realized that a relatively small number of our largest national banks—nine, to be exact—conducted over 90 percent of servicing activities engaged in by our entire national banking population. These banks service about 40 percent of all U.S. home mortgages outstanding. They are large and have in place the kind of information systems that allow them to produce significant amounts of data that can be tailored to particular requests. And perhaps most important, we as their primary federal regulator could require them to take several important steps: report to us loan-level data on roughly 23 million loans for homes in every state in the country, totaling $3.8 trillion; report such data in a common format, using standardized definitions; and validate the data submitted.

So, we seized this opportunity. The participating banks immediately understood both our needs and the value of producing more precise information using common metrics and definitions. They have worked closely with us and the third-party data aggregator we hired to begin reporting the extraordinary volume of information we have requested in the format we have established. And the aggregator has worked closely with us to translate key parts of that data into a report that can be issued to the public.

OCC'S FIRST MORTGAGE METRICS REPORT

Today, I am pleased to unveil findings from the first OCC Mortgage Metrics Report, which covers loan-level mortgage information for the last two calendar quarters, from October 1, 2007, to March 31, 2008. In the future, we plan to issue a Mortgage Metrics Report each quarter.

Before I summarize key results from this first report, let me explain how it differs from other reports and data collection efforts, and how it addresses concerns that I previously identified.

First, OCC Mortgage Metrics are comprehensive. They reflect activities of many of the industry's largest mortgage servicers—not just holders of the mortgages. In addition, the metrics capture information on all mortgages, not just subprime.

Second, the report is based on "loan-level" data. In contrast with other reports that rely on surveys of lenders or interpretations of data, we collected 64 specific pieces of information on more than 23 million loans for each month of the reporting period. These include such data elements as credit score, interest rate, unpaid balance, property value, and payment history. This loan-level data can be analyzed more rigorously and in a wider variety of ways than information obtained through surveys.

Third, our Mortgage Metrics use terms and definitions that are standardized. Today, if you simply ask lenders how many subprime loans they have, you'll get answers based on different definitions, because certain loans in one lender's subprime book may be another bank's Alt-A. Indeed, at the large national banks we supervise, the dividing line for prime, subprime, and Alt-A loans can vary widely across a range of credit scores and other characteristics of the loan and borrower. Our standardized Mortgage Metrics eliminate these disparities.

For example, the three categories of creditworthiness in the report—prime, Alt-A, and subprime—are defined using FICO credit scores at the time of loan origination. We use the following breakpoints that have often, but not always, been used by industry analysts: prime—660 and above; Alt-A—620 to 659; and subprime—below 620. Some may quibble with this particular segmentation, but the point is that they are the same quantifiable criteria used in every case, and as a result, "subprime" will mean the same thing for each servicer and each loan.

The metrics also establish a common—and conservative—definition for "newly initiated" loss mitigation actions. A payment plan or loan modification won't count unless the servicer and borrower have entered into an agreement. This results in fewer loss mitigation actions reported, but a better picture, we believe, of the actual occurrence of such actions.

Now, let me hasten to add that our new OCC metrics are not perfect. There has definitely been some "noise," especially in this large initial data collection looking backward for six months. For example, 20 percent of the loans fell into an "other" category, which meant that a credit score was unavailable. The inability to obtain such scores typically reflects problems with the flow of information through the systems that produce the data—purchased loan portfolios, for example, that came with databases that can't easily be read by the servicer's computer system. Now that the new data collection system has been established, we expect this problem to decline on a "go forward" basis as servicers realize that they will need this data whenever they acquire servicing portfolios in the future.

In addition to the "noise" in the overall data set, we need to be cautious about identifying trends in a six-month sample. Month-to-month data may be quite volatile and subject to fairly strong seasonal effects that can only be discerned from a longer time series that permits year-to-year comparisons. So observed changes month to month should be taken with a grain of salt.

Before turning to key results of the report, let me provide another important caveat: some of the conclusions we report here may seem different from conclusions that have been widely reported elsewhere—but there are good reasons for these differences. As I said previously, we believe the data is more precise than data reported in some other studies, and it reflects a huge proportion of the mortgages outstanding in the country. It obviously does not capture all mortgages, however, and it is not a statistically random sample.

The particular population of mortgages held and serviced by these nine national banks has some different characteristics than the overall population of mortgages. This difference can cause different results. For example, the proportion of subprime loans in the pool is smaller than in the general population—national banks service only about 25 percent of all subprime mortgages, but they service 40 percent of all mortgages outstanding. Similarly, the prime mortgages serviced by national banks include a disproportionately high number of conforming loans sold to the GSEs—about 66 percent, compared to 43 percent for the industry overall.

Finally, the standardized definitions produce different results. Other studies that don't break out Alt-A separately will lump these loans in either the prime category—thereby elevating delinquency and foreclosure ratios for those loans—or the subprime category—where it will have the opposite effect.

In short, while there are good reasons for the differences, the summary data from this first Mortgage Metrics report in some cases vary significantly from comparable categories recently reported in other surveys.

SIGNIFICANT FINDINGS

So, with that quite long wind-up, what does this first report tell us? Here are six key findings.

First, one somewhat surprising finding is that the overall mortgage servicing portfolio of the nine banks reflects credit quality that is relatively satisfactory and relatively stable. For example, the number of current and performing loans remained at about 94 percent over the entire six-month period. Serious delinquencies, which we define as bankrupt borrowers who are 30 days delinquent and all delinquencies greater than 60 days, increased just one tenth of a percentage point during the period, from 2.1 percent to about 2.2 percent. This overall quality and stability likely reflects the differences in the national bank servicing portfolio that I described above.

Second: Among the three segments of loans, we found, not surprisingly, that the majority of serious delinquencies was concentrated in the highest risk segment—subprime mortgages. Though these mortgages constituted less than 9 percent of the total portfolio, they sustained twice as many delinquencies as either prime or Alt-A mortgages.

The third finding concerns loss mitigation actions, which for purposes of this report include only loan modifications and payment plans. Consistent with other reports, payment plans predominated, outnumbering loan modifications in March by more than four to one. But loan modifications increased at a much faster rate during the period.

Servicers also indicated they are working with Fannie Mae, Freddie Mac, the Federal Housing Administration, and private investors to develop and offer new loss mitigation options. In fact, mortgage servicers reported several alternative loss mitigation actions not included in this analysis that we plan to include in future reports, including HomeSaver Advance, FHASecure, partial claims, new subsidy programs, and refinances with principal forgiveness. These actions provide banks additional alternatives to mitigate their risks and work with troubled borrowers.

Fourth: Although subprime mortgages made up less than 9 percent of the portfolio, they accounted for 43 percent of all loss mitigation actions at the end of March. Indeed, for these borrowers in that month, total loss mitigation actions exceeded newly initiated foreclosure proceedings by a margin of nearly 2 to 1.

Fifth: As in other studies, our report confirms that foreclosures in process are plainly on the rise, with the total number increasing steadily and significantly through the reporting period from 0.9 percent of the portfolio to 1.23 percent. Interestingly, the number of new foreclosures has been quite variable. While one month does not make a trend, new foreclosures in March declined to 45,696, down 21 percent from January's high and down about 4.5 percent from the start of the reporting period last October. Similarly, the ratio of new foreclosures to serious delinquencies was lower in March than in either January or October.

Sixth and finally, the data also show that seriously delinquent subprime loans had fewer new foreclosure starts than seriously delinquent prime or Alt-A mortgages. Why would troubled prime loans have more foreclosure starts than troubled subprime loans? One possible explanation is that the national emphasis on developing alternatives and assistance programs has been targeted to subprime borrowers, allowing a higher percentage of these borrowers to stave off foreclosure.

VALUE OF MORTGAGE METRICS

These are just a few of the key findings from the first report, which will be available on our Web site. I urge you to review it yourselves for other information that you may find useful. That's exactly what we are doing, both with this and the other data we have collected, since we believe it will serve a variety of useful purposes.

For example, the data will help us develop supervision policy and strategies. Examiners will be able to use the information to identify anomalies; compare national bank trends to the industry; evaluate asset quality and loan-loss reserve needs; and evaluate the effectiveness of loss mitigation actions. Over time, it will allow us to drill down to look at trends in performance based on origination channels or key credit characteristics. This in turn will help us more fully assess losses, loan modifications, payment plans, and recovery efforts.

In the future, I hope that the standard definitions and methodology used in this report will be applied more broadly to an even larger proportion of the pool of outstanding mortgages. The more we can use standardized metrics across the board, the better we can measure, monitor, and manage mortgage risk.

With this thought very much in mind, we have shared these standard definitions with the Office of Thrift Supervision, which has also begun requiring the thrifts it supervises to make similar monthly reports. If we could combine our results in future reports, the coverage would extend to 60 percent of all outstanding mortgages. We would also be interested in sharing the definitions and methodologies with other interested data collectors, like the state task force that is gathering data from a range of providers.

Going forward, we think it makes sense to have a national standard for mortgage reporting. The American Securitization Forum is in a position to help advance this process, and I would encourage you to join us in working toward a common and uniform mortgage reporting regime in the U.S.

While we think these metrics are useful, we know they are not perfect. We welcome input by other regulators and industry participants to refine and improve them going forward. In the end, we will all benefit from having more accurate and standardized mortgage metrics to make better business and policy decisions, and to avoid needless foreclosures.

Thank you very much.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM JOHN C. DUGAN

Q.1. Although not all the items that you suggested were included in this package and there might need to be a few tweaks, are there any items in this package that your agency cannot support or are these all items that would increase regulatory efficiency without compromising safety and soundness and important consumer protections?

Since all of these items have been, vetted and reviewed in past hearings before the Banking Committee, is there any reason to not move quickly forward with a package along these lines?

A.1. We have reviewed the regulatory burden relief amendments proposed by Senator Crapo in the amendment to the ILC legislation that the Senator filed, but did not offer, at the markup of that legislation held on February 13, 2008. Our comments follow:

- *Depository Institution Community Development Investments (Sec. 4)* [1]

This amendment would restore the original scope of national banks' public welfare investment authority pursuant to 12 U.S.C. § 24(Eleventh). Although the Financial Services Regulatory Relief Act of 2006 (FSRRA) [2] increased the permissible amount of national banks' public welfare investments, it also narrowed the applicable standard to require that such investments "benefit primarily" low- and moderate-income communities or families. As a result, national banks' ability to make public welfare investments, that would help economically distressed or underserved middle-income areas has been curtailed. The amendment would restore the original language of section 24(Eleventh) so that the applicable standard would

[1] Section numbers correspond with the section numbers in the Crapo amendment to the ILC legislation, which is the most recent version of the text of the provisions that we have seen.

[2] Pub. L. No. 109–351, § 305, 120 Stat. 1966, 1971–72 (Oct. 13, 2006).

once again be that investments must be “designed primarily to promote the public welfare.”

The OCC strongly supports the amendment,[3] and we.are grateful for Senator Crapo’s inclusion of it in this package, as well as his support for its inclusion in other legislative vehicles in this Congress.

- *Gramm-Leach-Bliley Act Amendment (See. 6).*

This amendment would eliminate the annual privacy notice requirement for those financial institutions that do not disclose nonpublic personal information to any nonaffiliated third party in a manner that would be subject to a consumer’s right to opt out under the Gramm-Leach-Bliley Act (GLBA) or the Fair Credit Reporting Act (FCRA) and that have not changed their disclosure policies since the most recent previous annual notice. The OCC supports this amendment. We note, as a technical matter, that the cross-reference to section 603 of the FCRA should read “section 603(d)(2)(A)(iii)” in order to capture precisely the non-transaction or experience information that is subject to customer opt-out.

- *Sarbanes–Oxley Act Amendment Relating to Community Bank Exceptions (Sec. 7)*

This amendment would except from the requirements of section 404 of the Sarbanes-Oxley Act (pertaining to auditor attestation of management’s assessment of internal controls) insured banks with consolidated assets of $1 billion or less. The OCC supports this Amendment.[4]

- *Examination Schedule for Certain Community Banks (Sec. 8)*

The OCC supports this amendment, which would raise from $500 million to $1 billion the asset-size threshold for banks to qualify for the expanded 18-month examination cycle authorized pursuant to the Federal Deposit Insurance Act.

- *Repeal of Delay of Certain Authority of the Board of Governors of the Federal Reserve System (Sec. 16)*

The OCC supported the amendment authorizing the Federal Reserve Board to pay interest on reserves, which was enacted as section 201 of the FSRRA.[5] We defer to the Board with respect to the elimination of the 5-year delayed effective date that was incorporated in section 201 and that would be repealed by this provision.

- *Authority for Interest on Demand Deposits (Sec. 17)*

The OCC supports this amendment, which would repeal the prohibition against banks’ and Thrifts’ offering interest on demand deposit accounts, effective 2 years after enactment.

- *Interest-Bearing Transaction Accounts Authorized for All Businesses (Sec. 18)*

[3] See Letter from John C. Dugan, Comptroller of the Currency, to Senator Mike Crapo, January 25, 2008 (identifying 4 items for inclusion in regulatory relief legislation). See also Remarks by John C. Dugan Before the National Ass’n of Affordable Housing Lenders, Washington, D.C., February 12, 2008, available at *www.occ.gov/ftp/release/2008-14a.pdf*.

[4] See Testimony of Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, March 1, 2006, at pp. 9–10 (OCC Testimony) (noting high cost of compliance with section 404 for smaller banks).

[5] Pub. L. No. 109–351, § 201, 120 Stat. at 1968–69.

The OCC supports this amendment, which would expand from 6 to 24 the number of permissible transfers made per month from money market deposit accounts. We note that the amendment would authorize the Federal Reserve Board to establish a greater number of transfers by rule or order and would permit "the Board to determine that such an account is not a "transaction account" for purposes of section 19 of the Federal Reserve Act (subjecting "transaction accounts" to reserve requirements). We defer to the Board with respect to these grants of discretionary authority.

We agree that all of the above-mentioned items would increase regulatory efficiency without compromising safety and soundness or consumer protections, and we see no reason to delay a legislative package that includes them.

The OCC takes no position with respect to the provisions relating to the authorities of Federal savings associations (sections 5, 9, and 10), and we express no view with respect to the provisions relating to credit unions (sections 11, 12, 13, 14, and 15).

Finally, should the Committee wish to entertain additional amendments for inclusion in a regulatory burden relief legislative package, we have attached legislative language that would implement the two additional provisions that were recommended in Comptroller Dugan's letter to Senator Crapo of January 25, 2008. These provisions are: (1) the repeal of the state opt-in requirement for de novo branching and of the 5-year state age requirement; and (2) the elimination of the "place of 5,000" requirement from national banks" general insurance agency sales authority. The attached legislative language is identical to the language provided with the January 25 letter.

MAY 13, 2008.

ADDITIONAL OCC REGULATORY BURDEN RELIEF SUGGESTIONS [1]

1. Repeal the State Opt-In Requirement for *De Novo* Branching and Repeal the 5-Year State Age Requirement

2. Delete the "place of 5,000" requirement from national banks' general insurance agency sales authority

1. SEC ____. EASING RESTRICTIONS ON INTERSTATE BRANCHING AND MERGERS.

(a) DE NOVO INTERSTATE BRANCHES OF NATIONAL BANKS.—Section. 5155(g) of the Revised Statutes of the United States (12 U.S.C. 36(g)) is amended—

(1) in paragraph (1), by striking "paragraph (2)" each place that it appears and inserting "paragraph (3)"; and

(2) by inserting after paragraph (1) the following new paragraph and renumbering the remaining paragraphs. accordingly:

"(2) STREAMLINED PROCEDURES FOR CERTAIN BANKS.—

"(A) IN GENERAL.—The requirements in paragraph (1)(A) shall not apply to the establishment and operation of a de novo branch by a national bank if—

[1] These two amendments are identical to those submitted to Senator Crapo earlier this year. See Letter from John C. Dugan, Comptroller of the Currency, to Senator Mike Crapo, January 25, 2008 (identifying items for inclusion in regulatory relief legislation).

"(i) the bank is a subsidiary of a bank holding company which is operating as a bank holding company subject to the supervision and regulation of the Board of Governors of the Federal Reserve System under the Bank Holding Company Act of 1956 (12 U.S.C. 1841, et seq.); or

"(ii) the bank is not controlled by a company for purposes of the Bank Holding Company Act of 1956.

"(B) DEFINITIONS.—For purposes of this paragraph, the terms 'subsidiary', 'bank holding company', and 'company' have the same meaning given to such terms in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841)."

(b) DE NOVO INTERSTATE BRANCHES OF STATE NONMEMBER BANKS.—Section 18(d)(4) of the Federal Deposit Insurance Act (12 U.S.C. 1828(d)(4)) is amended—

(1) in subparagraph (A), by striking "subparagraph (B)" each place that it appears and inserting "subparagraph (C)"; and

(2) by inserting after subparagraph (A) the following new subparagraph and redesignating the following subparagraphs accordingly:

"(B) STREAMLINED PROCEDURES FOR CERTAIN BANKS.—

"(i) IN GENERAL.—The requirements in subparagraph. (A)(i) shall not apply to the establishment and, operation of a de novo branch by an insured state nonmember bank if—

"(I) the bank is a subsidiary of a bank holding company which is operating as a bank holding company subject to the supervision and regulation of the Board of Governors of the Federal Reserve System under the Bank Holding Company Act of 1956 (12 U.S.C. 1841, et seq.); or

"(II) the bank is not controlled by a company for purposes of the Bank Holding Company Act of 1956.

"(ii) DEFINITIONS.—For purposes of this paragraph, the terms 'subsidiary', 'bank holding company', and 'company' have the same meaning given to such terms in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841)."

(c) DE NOVO INTERSTATE BRANCHES OF STATE MEMBER BANKS.—The 3rd undesignated paragraph of section 9 of the Federal Reserve Act (12 U.S.C. 321) is amended by adding at the end the following new sentences: "A State member bank may establish and operate a de novo branch in a host State (as such terms are defined in section 18(d) of the Federal Deposit Insurance Act) on the same terms and conditions and subject to the same limitations and restrictions as are applicable to the establishment of a de novo branch of a national bank in a host State under section 5155(g) of the Revised Statutes of the United States, Section 5155(g) shall be applied for purposes of the preceding sentence by substituting 'Board of Governors of the Federal Reserve System' for 'Comptroller of the Currency' and 'State member bank' for 'national bank'.".

(d) CONFORMING AMENDMENTS.—

(1) FEDERAL DEPOSIT INSURANCE ACT.—Section 44(a) of the Federal Deposit Insurance Act (12 U.S.C. 1831u(a)) is amended by striking paragraphs (5) and (6); and

(2) BANK HOLDING COMPANY ACT.—Section 3(d) of the Bank Holding Company Act of 1956 (12 U.S.C. 1842(d)) is amended—

(A) in paragraph (1)—

(i) by striking subparagraphs (B) and (C); and

(ii) by redesignating subparagraph (D) as subparagraph (B); and

(B) in paragraph (5), by striking "subparagraph (B) or (D)" and inserting "subparagraph (B)".

EXPLANATION

This section would amend section 5155(g) of the Revised Statutes of the United States (12 U.S.C. § 36(g)), section 18(d)(4) of the Federal Deposit Insurance Act (FDIA) (12 U.S.C. § 1828(d)(4)), section 9 of the Federal Reserve Act (12 U.S.C. § 321), and section 3(d)(1) of the Bank Holding Company Act (BHCA) (12 U.S.C. § 1842(d)(1)) to ease certain restrictions on interstate banking and branching. Under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal Act), an out-of-state national or state bank may establish a *de novo* branch in a state only if that state has adopted legislation affirmatively "opting in" to *de novo* branching.

This amendment would repeal the requirement for certain national and state banks that a state must opt-in to *de novo* branching to allow this form of interstate branching in the state. The language of this amendment is different from the version that was included in Sec. 401 of H.R. 3505 and may offer a solution to the issues concerning permitting state-nonmember-bank industrial loan companies (ILCs) controlled by commercial companies to engage in unrestricted *de novo* branching that has impeded the enactment of this amendment in past Congresses. As explained below, ILCs controlled by commercial companies that are not supervised or regulated by the Federal Reserve Board (Fed) under the BHCA would not be allowed to engage in *de novo* branching without the state opt-in requirement under the amendment.

This amendment would repeal the requirement that a state must adopt an "opt-in" statute to permit the *de novo* branching form of interstate expansion but it would repeal the requirement only for those national or state banks that are organized in one of two ways. First, the amendment would exempt a national or state bank from the state opt-in requirement if it is a subsidiary of a bank holding company which is operating as a bank holding company under the supervision and regulation of the Fed in accordance with the BHCA. Second, a national or state bank would be exempt from the state opt-in requirement if it is not controlled by a "company" for purposes of the BHCA. Thus, the amendment would repeal the state opt-in requirement for any national or state bank that is a subsidiary of a bank holding company or is not controlled by any company under the BHCA Banks that are subsidiaries of supervised bank holding companies or banks that are independent and are not controlled by a company would be able to engage in interstate *de novo* branching without being subject to the state opt-in requirement.

Neither of the two exempt forms of organization, however, would apply to a bank, such as an ILC that' is controlled by a commercial company. While an ILC is a state nonmember bank, it is exempt from the definition of a "bank" under the BHCA if certain conditions are satisfied and, as a result, its parent company is not subject to the BHCA and may be a commercial firm. These commercial firms are companies for purposes of the BHCA but, because they do not control a "bank" under the BHCA's definition of "bank", they do not operate as bank holding companies under the Federal Reserve Board's (Fed) supervision and regulation and are not subject to the restrictions on commercial operations that apply to regulated and supervised bank holding companies. Neither of the exemptions in the amendment would apply to ILCs controlled by commercial firms and they would not be able to engage in unrestricted *de novo* branching under the amendment.

The amendment also would repeal the state age requirement for interstate mergers. The Riegle-Neal Act permits a state to prohibit an out-of-state bank or bank holding company from acquiring an in-state bank unless the state bank has been in existence for a minimum period of time (which may be as long as five years). This additional limitation on bank acquisitions by out-of-state banking organizations is no longer necessary if interstate *de novo* branching generally is permitted for most banks under the amendment described above.

Under the Riegle-Neal Act, interstate expansion through bank mergers generally is subject to a state "opt-out" that had to be in place by June 1, 1997. While two states "opted out" at the time, interstate bank mergers are now permissible in all 50 states. By contrast, *de novo* branching by banks requires states to pass legislation to affirmatively "opt-in" to permit out-of-state banks to establish new branches in the state and only approximately 23 states have opted in (17 of which require reciprocity). As a result, banks in many cases must structure artificial and unnecessarily expensive transactions in order to simply establish a new branch across a state border. However, Federal thrifts are not similarly restricted and generally may branch interstate without the state law "opt-in" requirements that are imposed on banks. Also, repeal of the state age requirement would remove a limitation on bank acquisitions by out-of-state banking organizations that is no longer necessary if interstate *de novo* branching generally is permitted.

Enactment of this amendment would enhance competition in banking services with resulting benefits for bank customers. Moreover, it will ease burdens on banks that are planning interstate expansion through branches and would give banks greater flexibility in formulating their business plans and in making choices about the form of their interstate operations. Community banks that seek to serve customers across state lines would especially benefit since they lack the resource base available to larger banks that is required to structure the more complicated transactions now required to accomplish that result.

2. SEC.____. DELETING THE "PLACE OF 5,000" REQUIREMENT FROM NATIONAL BANKS' GENERAL INSURANCE AGENCY SALES AUTHORITY.

The 11th undesignated paragraph of section 13 of the Federal Reserve Act (12 U.S.C. 92) is amended by striking "located and doing business in any place the population of which does not exceed five thousand inhabitants, as shown by the last preceding decennial census,".

EXPLANATION

Under current law, unlike state banks, national banks cannot engage in general insurance *agency* activities unless the bank is "located and doing business in any place the population of which does not exceed five thousand inhabitants, as shown by the last preceding decennial census" ("place of 5,000 restriction"), or unless the national bank establishes a financial subsidiary. The Gramm-Leach-Bliley Act (GLBA) generally provides authority for financial subsidiaries of national banks to engage in general insurance agency activities subject to the capital, managerial, CRA requirements, and other safeguards in GLBA that, apply to the establishment and operation of financial subsidiaries under GLBA.[2] These requirements do not apply to state banks engaged in insurance agency activities.[3] The Conference of State Bank Supervisors reports that all states but one permit their banks to sell insurance as agent and only a very few impose the place of 5,000 restriction that applies to all national banks.[4] There is no safety and soundness reason to competitively disadvantage national banks and subject them to the place of 5,000 restriction or require that these less risky agency activities must be conducted in a financial subsidiary subject to the capital deduction requirements and other safeguards while most state banks can engage in the same agency activity without these restrictions. This amendment would repeal the place of 5,000 restriction and permit national, banks to sell insurance as agent in the same manner as state banks without the GLBA financial subsidiary requirements.[5] Notably, nothing in this amendment would

[2] To qualify to have a financial subsidiary to engage in general insurance agency activities without the place of 5,000 restriction, the national bank and each depository institution affiliate must be well capitalized and well managed, and the national bank's aggregate consolidated total assets of all of its financial subsidiaries is subject to a cap. In addition, certain other safeguards apply, including a requirement that, for purposes of determining regulatory capital, the national bank must deduct its outstanding equity investment in its financial subsidiaries from its total assets and tangible equity, must deduct the investment from its total risk-based capitals, and may not consolidate the assets and liabilities of a financial subsidiary with those of the bank. A national bank that ceases to continue to satisfy these requirements is subject to sanctions by the OCC, including divestiture. A national bank and its insured depository institution affiliates also are subject to CRA rating requirements when the bank acquires control of a financial subsidiary or engages in new activities in the subsidiary. 12 U.S.C. §§ 24a; 1831w.

[3] The GLBA financial subsidiary requirements and safeguards apply only to insured state banks engaging as *principal* in national bank permissible financial activities in a subsidiary. If the state bank is engaged in agency activities in a subsidiary, such as selling insurance as agent, none of the requirements and safeguards apply under GLBA. *Id* at § 1831w. Moreover, the requirement that a state bank must obtain the approval of the FDIC to engage directly or through a subsidiary in activities that are impermissible for a national bank or its subsidiary also applies only to activities conducted as *principal* and, thus, because of the less risky nature of agency activities, the FDIC is not required to approve state bank insurance agency activities. *Id*. at § 1831a.

[4] *See* The Conference of State Bank Supervisors, *A Profile of State Chartered Banking Twentieth Edition 2004/2005* Section III 9–12 (2005).

[5] Item #137 in the Matrix of Financial Services Regulation Relief Proposals compiled by Sen. Crapo's staff in the 109th Congress would have given the Fed the authority to permit all bank holding companies, including those bank holding companies that do not elect or may not be eligi-

affect the functional regulation of insurance activities as provided by GLBA.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM JOHN M. REICH

Q.1. Last year, the Department of Labor issued a regulation drastically expanding the personal financial information union officers and employees must submit to the Department. The new LM–30 rule will require more than 150,000 union volunteers, employees, and their families to report the terms of mortgages, car loans, and even student loans. To determine whether they must report such interests, these individuals must ascertain (1) whether the bank providing a loan does any business with the person's union, or (2) whether the bank does 10 percent of its business with firms whose employees are in the same union. The regulation requires individuals to write to banks asking for this info, and, then, if banks won't provide such information, to contact the Department of Labor for assistance. In the meantime, individuals are required to make good faith estimates of the bank's business with their unions and unionized firms.

Given your agency's expertise in the regulation and practices of banks, do you believe that banks are able—and willing—to inform their customers whether they do business with particular unions and how much of their "business" and "business receipts" are with particular unionized firms?

Are banks obligated or prohibited by any federal or state law to disclose to their customers how much "business" or "business receipts" they have with particular unionized firms? Can banks simply refuse to answer these written inquiries?

What type of administrative burden will this LM–30 rule, and the hundreds of thousands of resulting inquiries, place on banks and are banks currently prepared to respond to these inquiries?

If banks don't provide this non-public information, is there any "information reasonably available" to the public that union officers, employees, and members could use to make good faith estimates?

A.1. The Labor-Management Reporting and Disclosure Act (LMRDA) requires public disclosures of certain financial transactions and financial interests of labor organization officers and employees (other than employees performing clerical or custodial services exclusively) and their spouses and minor children. It is our understanding that the purpose of this disclosure is, among other things, to make public any actual or potential conflict between the personal financial interests of a labor organization officer or employee and his or her obligations to the labor organization and its members.

The U.S. Department of Labor's Office of Labor-Management Standards (OLMS) issued a final rule in 2007 implementing section

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ble to become financial holding companies, to engage in general insurance agency activities through a nonbank affiliate. Both bank holding companies and national banks are subject to the place of 5,000 restriction or must rely on the authority in GLBA to engage in broad, general insurance agency sales activities subject to the requirements and restrictions that apply to financial holding companies and financial subsidiaries, respectively. The OCC opposed Item #137 unless the amendment above is also adopted similarly permitting national banks to engage in general insurance agency activities.

202 of LMRDA. See 72 FR 36106 (July 2, 2007). The final rule revised Form LM–30, Labor Organization Officer and Employee Report, and its instructions. The final rule became effective for fiscal years beginning August 16, 2007, although no reporting is due under the rule until November 16, 2008. See 72 FR 38484 (July 13, 2007).

OTS understands that financial institutions are expressly relieved of any reporting responsibilities of payments or loans under section 203 of the LMRDA (see 72 FR at 36119 and 36136). Therefore, savings associations are not required to report customer information.

The final rule deals with Form LM–30, which requires reporting by the union officers and employees covered under the LMRDA. The final rule, as revised, does not require union officers to report most bona fide loans, interest, or dividends from financial institutions. However, the final rule may require that union officers report these types of transactions if the bank does a specified level of business with a company that employs members of the same union. The OLMS is the agency responsible for implementation and interpretation of this regulation, and OTS defers to OLMS's determination of the exact parameters of the categories where union employees are required to report bank loans.

We know of no federal law that either requires or forbids a financial institution from informing its customers whether they deal with businesses that are unionized and what union represents the employees of those businesses, assuming that no customer information is disclosed. We see nothing in the Department of Labor rule that would require financial institutions to make those disclosures. We note that savings associations typically build certain reporting codes into their information management systems to facilitate the creation of both regulatory related filings, such as Thrift Financial Reports, as well as internal management reports. The basis for distinguishing and reporting based upon the type of union-related activity at issue here may not be a part of this reporting framework, thereby creating issues regarding the practicality of disclosure.

OTS will continue to analyze the impact of the final rule on our supervised savings associations as we approach the November 2008 reporting deadline.

Q.2. In December 2006, three agencies, the FRB, OCC, and FDIC, issued final guidance highlighting the risks to banks from concentrations in commercial real estate. In issuing the guidance, the regulators specifically emphasized that they were not setting any limits on banks' commercial real estate lending. Yet now we understand from the Comptroller of the Currency and the Chair of the FDIC that over a third of community banks have commercial real estate concentrations exceeding 300 percent of their capital.

- Are any community banks going to fail because of their overexposure to commercial real estate, including commercial real estate mortgage backed securities?
- Was it the correct policy not to set concentration limits in the guidance?
- Why did the OTS decline to join in issuing the final guidance, even after the OTS joined in the proposed guidance?

- What are examiners doing when they find these levels of concentrations?
- Are banks using off-balance sheet vehicles to invest in commercial real estate? If so, please describe. Are the regulators approving these kinds of transactions?

A.2. While OTS has observed an increase in the commercial real estate portfolios at some of our institutions, we have not seen any indication that there is an overexposure that would result in failure, particularly at community banks. In anticipation of the risk associated with this type of lending, our examiners utilize both onsite and offsite monitoring of these exposures at our institutions.

On January 4, 2006, OTS joined the Office of the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation in publishing proposed CRE guidance in the Federal Register for notice and comment. When the comment period ended, OTS had received approximately 1300 comment letters from savings associations, banks, trade associations, and individuals.

Comments centered on three themes: the overly broad scope of the guidance, specifically that low risk multifamily and non-speculative construction loans be excluded from the CRE definition; the inappropriateness of rigid thresholds used to identify institutions with CRE concentrations because actual concentration risk varies so much with the type of CRE lending and an institution's risk management practices; and the potential chilling effect of the supervisory thresholds on community banks' lending practices.

OTS significantly revised the Guidance to address concerns expressed through the comment process. The primary focus of the final Guidance issued by OTS is the expectation that savings associations actively engaged in CRE lending, especially those that are entering or rapidly expanding CRE lending, should:

(1) Perform an internal self-assessment of exposure to concentration risk; continually monitor potential exposure to such risk; and report any such identified concentration risk to senior management and the board of directors; and

(2) Implement risk management policies and procedures appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risks, to monitor and manage those risks effectively.

Although the guidance issued by the other Agencies contains numerical screens to be used for supervisory oversight, OTS decided not to include such screens in its guidance for several reasons. OTS's experience recognizes that concentration risks may be present at levels well below the other Agencies' thresholds. While savings associations are uniquely subject to a 400 percent of capital statutory investment limit on nonresidential real estate lending, through existing guidance and practice, OTS expects savings associations to continuously assess and manage concentration risk. OTS conducts quarterly monitoring of savings associations' portfolio composition to assess each association's exposure to concentration risk. Accordingly, OTS determined that inclusion of numerical thresholds in the guidance was unnecessary for savings associations and could result in unintended consequences and confusion in the industry. On December 14, 2006, OTS issued separate CRE guidance to the industry it supervises. Even in the current economic environment, we continue to believe that this was the correct policy to establish for the thrift industry.

Finally, OTS has not observed any institutions using off-balance sheet vehicles to invest in commercial real estate and have not received any applications to engage in this type transaction.

Q.3. There was extensive conversation on what would have been the capital status of banks going into this crisis period had Basel II capital standards been in effect. Fed Vice-Chairman Kohn said that if, “we had the same safeguards in place, and if we started implementing in 2004 with the same safeguards that are in place in 2008 and 2009, I do think on balance we would have been better off.” Mr. Gronstal answered differently, stating: “I think the answer to your second question is that we probably would have had lower dollar amounts of capital per asset, and that makes it more challenging to deal with issues when times get rough.”

Can you explain in writing, whether you believe that banks would have had more or less capital in place for this current down turn had Basel II been implemented during the time frame that Vice-Chairman Kohn mentioned in his response? Can you also explain why you believe that to be the case, citing any empirical data on both the effects of Basel II on capital requirements and what we have experienced during this economic crisis, as it relates to assets?

During the discussion of Basel II, Comptroller Dugan told the Committee: “The irony of this whole situation is that the very high—most highly rated best securities, the ones that were thought to be least likely to default was where all the—a huge share of the losses have been concentrated.” Given Basel II’s reliance on ratings of securities, does this observation give you reason for concern over the current Basel II structure? If so, what do you recommend be done; if not, why not?

A.3. It is OTS’s view that applying the Basel II Advanced Approaches Final Rule as if it were in place going into the crisis period carries too many subjective empirical and supervisory assumptions for it to be a meaningful exercise. In fact, doing so discounts the critical safeguards the federal banking agencies included in the rule. Only in the U.S. did we include a 4-year implementation period. We include a first year parallel run, followed by 3 years with capital floors. At each step, a bank can only move on with supervisory approval.

In addition, each of the agencies has committed to make necessary framework changes along the way to maintain capital levels commensurate with risk, to ensure safe and sound banking system. This is truly an evergreen rule. While developed during a benign economic period, the agencies have been adamant about making changes, as needed, to anticipate a stress period. Today banks are still building the framework by which they will estimate potential loss. We anticipate that the current experience with real stress, as opposed to theoretical assumptions, should yield even more rigorous loss estimates as we move through the years of implementation. Finally, the agencies have also committed to undertake a study of the Advanced Approach after we obtain sufficient data from the parallel run period. That study will provide the basis for any refinements to the framework or the regulation.

In response to questions about ratings, the agencies, as part of the international effort of the Basel Committee on Banking Supervision, have already begun studying the causes of and potential responses to the limitations of bank reliance on ratings, especially within the securitization framework. We are also nearing the time when the agencies will bring forward a Notice of Proposed Rulemaking to introduce a Basel II Standardized Approach to the U.S. In that proposal, we will specifically seek comments on use of ratings for risk-based capital purposes.

In sum, long before any new capital framework is in place and fully operational for any banks or thrifts, the agencies will be able to assess the current crisis in hindsight, and make whatever refinements are necessary to Basel II capital standards to ensure the continuation of a safe and sound U.S. banking system.

Q.4. I am concerned about the potential ramifications of the failure of a very large institution. Is your agency prepared today to handle the failure of a large systemically significant insured financial institution? What steps are you taking to prepare for this contingency?

A.4. OTS is continually monitoring the safety and soundness of our largest thrift institutions by maintaining a continuous examination presence at these institutions. This approach allows OTS to receive real time information regarding the health and risk exposures of these institutions. OTS actively works with the FDIC to address any risk of failure of the institutions we supervise. In addition to continuing communications with the FDIC, OTS shares Thrift Financial Report data, examination data and other institution data with the FDIC to insure that any information that could indicate an increased potential for failure is analyzed in a timely manner and would allow sufficient opportunity for the FDIC to take necessary steps in the event of a failure.

Q.5. Please provide comprehensive data on mortgage delinquencies, foreclosures, repayment plans and modifications for the mortgages being serviced by the institutions you regulate for the past 12 months. Please provide this information by the following loan categories: subprime, Alt-A, and prime. Please describe the types of repayment plans and modifications that servicers are employing and the numbers of loans in each category.

A.5. OTS, along with the other federal banking agencies, issued a Statement on Working with Borrowers on April 17, 2007, communicating our supervisory expectation that institutions we supervise work with borrowers having financial difficulty repaying their mortgages. Since that issuance, and as a part of our ongoing supervisory process, OTS contacted its six largest servicers in March of this year to establish and initiate a nationwide horizontal review of mortgage loan servicing data. We believe it is necessary to obtain this comprehensive mortgage data to assure that we have a detailed, current, and on-going picture of mortgage loan performance and loan modification efforts.

OTS believes it is important to obtain key mortgage performance metrics across a broad spectrum of products, and therefore, our data collection request covers mortgages held on book by savings associations and their subsidiaries, in addition to loans serviced for others. In particular, the scope of the mortgage data we are requesting is not limited to subprime mortgages serviced for mortgages in securitization pools. The mortgage data we are seeking uses common definitions and data elements for asset quality metrics (delinquency measures, foreclosures, etc.), loss and foreclosure mitigation actions taken, and segmentation by credit quality risk indicators (such as FICO scores). With this approach, we will have data that are consistent, comparable, and reliable.

We also believe it is important to build upon, and not conflict with, the mortgage data collection efforts of the HOPE NOW Alliance, whose members constitute a broad cross-section of industry and community organizations working to tackle the foreclosure crisis. In order to achieve that objective, we have retained the HOPE NOW Alliance data aggregator, McDash Analytics, LLC, to process the data submissions for us. The servicers submit the requested data to McDash Analytics. McDash compiles the information and provides reports directly to the OTS. We will receive our initial data reports from McDash in May.

In advance of receiving the data from each of our servicers, OTS's preliminary discussions with several of our servicers indicate that loan workout activity at our institutions has increased dramatically over the past twelve months. The servicers indicate that the activity is inherently costly and does not always result in successful loan modifications. However, the public perception of the willingness of lenders to work with borrowers has grown, resulting in a much better response rate of borrowers to outreach efforts.

Several of our servicers have indicated that early contact and open communications with borrowers is the most critical step in helping to prevent default. It allows the servicer to understand a borrower's specific needs and circumstances in order to prescribe a viable solution. There are several approaches that are being utilized to reach out to borrowers including personalized resource mailings, telephone calls to delinquent borrowers, and the use of automated commitments to pay.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM JOHN M. REICH

Q.1. Although not all the items that you suggested were included in this package and there might need to be a few tweaks, are there any items in this package that your agency cannot support or are these all items that would increase regulatory efficiency without compromising safety and soundness and important consumer protections?

A.1. Removing unnecessary regulatory obstacles that hinder customer service, innovation, competition, and performance in our financial services industry, and that also impede job creation and economic growth in the general economy, is an important and continuing objective of OTS. Although we have accomplished much in recent years to streamline and eliminate some of the burdens faced by the thrift industry, there remain many other areas for improvement. OTS is committed to reducing regulatory burden wherever it has the ability to do so, consistent with safety and soundness and compliance with law, and without undue impact on existing consumer protections. We support proposed legislation that advances this objective.

Q.2. Since all of these items have been vetted and reviewed in past hearings before the Banking Committee, is the reason to not move quickly forward with a package along these lines?

A.2. OTS encourages Congress to take swift action. These issues have been thoroughly vetted and there is no reason not to move forward in a timely fashion. It is incumbent on us to remain committed to reducing regulatory burden whenever we have the ability to do so, consistent with safety and soundness, and without undue impact on existing consumer protections. OTS would strongly support proposed legislation that advances this objective.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM JOANN M. JOHNSON

Q.1. What is the extent of losses to the Share Insurance Fund in 2007, particularly in the 4th quarter of 2007? How does that compare to previous years? To what extent do those losses result from those failures?

A.1. In 2007 the National Credit Union Share Insurance Fund (NCUSIF) incurred charges of $40.8 million. To fund specific and non-specific reserves the NCUSIF expensed $186.4 million in 2007, with $161 million occurring in the fourth quarter. Three credit unions conserved in 2007 accounted for $178.2 million of total expenses. Even with the higher level of actual charges and increased reserve expense in 2007, the NCUSIF finished the year with a 1.29 percent equity ratio, which closely approximates the targeted 1.30 percent level set by the NCUA Board.

The Table below reflects the NCUSIF's expenses, charges, and reserve balance for the last 7 years.

In millions	2001	2002	2003	2004	2005	2006	2007
Provision for Reserve Expense	$0	$12.5	$38.0	($3.4)	$20.9	$2.5	$186.4
Actual Charges to the NCUSIF	$4.7	$16.0	$8.8	$6.2	$15.6	$5.3	$40.8
Reserve Balance	$51.0	$47.5	$76.7	$67.1	$73.0	$70.2	$215.8

As part of our continual analysis of the NCUSIF, NCUA stress tests the Fund under various catastrophic scenarios. The analysis completed in late 2007 shows the Fund performing favorably under the various scenarios, confirming the strength of the NCUSIF. The charges for 2007 are significantly below the stress levels we employ. The actual charges in 2007 are also significantly below the last period of significant economic downturn. The loss per thousand dollars of insured shares for 2007 was $0.07 versus the actual range from 1991–1993 of $0.42 to $0.60.

Q.2. With respect to Norlarco, how did such a significant and problematic situation develop so quickly? Was NCUA aware of the situation, or of any warning signs, before the failure occurred?

A.2. The problem did not develop rapidly, but instead over approximately a 20 month time horizon, from October 2004 through June 2006. NCUA was aware of the situation at Norlarco Credit Union, a state chartered institution, and were using progressive enforcement steps to resolve the problems which included documents of resolution, state directives, a cease and desist order, and then ultimately conservatorship.

The FAM Program. Norlarco Credit Union had experience dealing with First American Mortgage, (FAM) a residential construction loan broker and servicer, for loans made within Colorado. These activities were reviewed as part of a June 2004 examination conducted jointly with the Colorado state regulator. When FAM began brokering and servicing loans in Florida, Norlarco Credit Union had already developed a relationship with and trust in the quality of services provided. With the establishment of the Florida program in October 2004 came a guarantee by both the homebuilder and FAM. The credit union had an understanding that the loans made were short term, fully guaranteed and carried a higher return than would be received through a similar short term investment. Actual delinquency did not begin to show in these loans until early 2007.

NCUA Supervision. Annually, NCUA examines approximately 18 percent of state chartered federally insured credit unions based on insurance risks. In the case of Norlarco, NCUA saw an increase in loan participations sold in late 2004 and that led the Agency to put this credit union on the 2005 examination list. In August 2005, as part of our work on another case, we determined that Norlarco had funded over 1,000 loans in Florida. During NCUA's joint examination conducted with the Colorado state regulator in October 2005, we discovered that the credit union had entered into a funding commitment with FAM for $30 million per month. NCUA's focused on improving the credit union's risk concentration and liquidity. Normal monitoring in March 2006 showed improvements in liquidity after the funding agreement was ceased. NCUA performed a supervision contact in May 2006 that revealed a prevalence of maturity extensions and led to questions surrounding the builder guarantees. At that contact, NCUA directed the credit union to cease funding any new residential construction loans. The growth in the portfolio after this contact was only through loans already in the pipeline after the credit union was required to cease and completion of loan commitments for homes already started.

NCUA's February 2007 contact set in place more stringent required board actions based on the problems identified with the various contracts, FAM's inability to honor their guarantees, the decrease in housing values in Florida, and new management's lack of understanding of the program risks. NCUA also required the credit union to report all the loans as member business loans unless they could show affirmative proof that they were not investor owned properties. In April 2007, due to unsafe and unsound management practices being initiated to keep the loans artificially shown as non delinquent, the state issued a cease and desist order. A major component of that order was a full contract review of all participation, FAM, builder, and borrower contracts that had yet to be completed despite prior directives to do so. The preliminary review showed significant risk and led to the state regulator's conservatorship action in May 2007. As part of the conservatorship action, NCUA decided to continue funding loans till houses were complete. The rationale for doing so was the higher salability of finished homes versus incomplete construction loans.

In summary, a combination of factors impacted the rapid development of the situation at Norlarco Credit Union. The credit union used a third party mortgage broker to originate residential construction loans (RCL) throughout the country, primarily to members in one of their two associational groups in their field of membership. By using a third party, the credit union was able to amass a significant portfolio in a relatively short period of time.

The type of loan granted was often inaccurately captured in the RCL loan applications processed by the third party underwriter. Credit union management did not exercise sufficient oversight of the program to validate whether the loans were for an individual's principal or secondary residence, or for speculative investment purposes.

It was not until near the end of this program that the real estate prices in Florida experienced a dramatic and rapid decline that resulted in speculative investors defaulting on their commitments.

Q.3. To what extent were the losses a result of member business lending?

A.3. Predominantly, the Florida loans made by Norlarco Credit Union were presented by the mortgage broker as owner-occupied properties. Following NCUA's January 2007 examination contact, NCUA required the credit union to report all the loans as member business loans proven otherwise. This resulted in approximately 80% of the portfolio being reclassified as member business loans for investor properties. The loans were all for residential construction and not for commercial construction properties.

Irrespective of the classification, these loans were residential property loans, and the collapse of the Florida real estate market was the largest factor in the failure.

Q.4. In cases where the development of the concentration of high-risk assets occurs within relatively short periods—and in this situation it appears to have developed over a matter of months—how does NCUA respond before failures become likely?

A.4. NCUA's overall regulatory philosophy calls for effective not excessive regulation and supervision. Consequently, NCUA pursues a progressive approach to enforcement actions. NCUA balances aggressive supervision against the adverse effects on credit union innovation. Credit unions are in business to take reasonable and prudent risks in serving their members. NCUA is mindful of the need for vigilant supervision in the context of allowing credit unions to provide consumer-oriented financial services.

During much of the Norlarco Credit Union situation, the high-risk nature of the assets was obscured by a guarantee contract, the short term nature of the loans, and the home value appreciation in the Florida market. Levels of delinquency and loan losses were masked by unilateral extensions made by the loan servicer, a practice that is not unusual in construction lending and were not in and of themselves unsafe and unsound practices. The fact that the loans were primarily investor properties, and therefore at higher risk than the owner-occupied properties (as reported) was not uncovered by NCUA until a more detailed loan was done as part of an examination.

NCUA's initial source of information about an insured credit union is the quarterly call report. Review and analysis of trends contained in Norlarco's Call Report established the need for the credit union to be part of a more stringent joint examination program, in conjunction with the state regulator. Through off-site monitoring NCUA increased the level of supervision over Norlarco Credit Union as its balance sheet, income statement and off-balance sheet commitment deteriorated. Although the institution failed due to a "perfect storm" of circumstances, it is a case where our off-site supervision combined with on-site examination supported the increased enforcement actions taken by both the state regulator and NCUA.

The credit unions associated with the Florida loans represented isolated instances of credit union failing to manage a third party loan program that grew very quickly, resulting in a high concentration of real estate loans at a time when real estate values suffered a precipitous decline. NCUA issued guidance in December 2007 and April 2008 to credit unions and field staff addressing third party due diligence and oversight.

Q.5. In light of Norlarco, what new efforts is NCUA making to identify such credit unions with such rapidly increasing levels of risk?

A.5. NCUA has intensified its review of emerging trends in credit union risk profiles. NCUA compiles quarterly risk reports and develops custom analysis based on aggregate trends in order to identify credit unions with increasing potential exposure. Field staff also regularly reviews risk reports in an effort to identify emerging risks in the credit unions they supervise. Changes to NCUA risk reports focus on growth in loan categories, share accounts, and borrowings in an effort to identify credit unions in the early stages of programs such as those involving the Florida loans.

Additional emphasis is also being placed on reviewing third party arrangements and loan participation sales and purchases, as evidenced by recent examiner and industry guidance.

ANTI-UNION REGULATION

Q.6. Last year, the Department of Labor issued a regulation drastically expanding the personal financial information union officers and employees must submit to the Department. The new LM–30 rule will require more than 150,000 union volunteers, employees, and their families to report the terms of mortgages, car loans, and even student loans. To determine whether they must report such interests, these individuals must ascertain (1) whether the bank providing a loan does any business with the person's union, or (2) whether the bank does 10 percent of its business with firms whose employees are in the same union. The regulation requires individuals to write to banks asking for this info, and, then, if banks won't provide such information, to contact the Department of Labor for assistance. In the meantime, individuals are required to make good faith estimates of the bank's business with their unions and unionized firms.

A.6. With respect to credit unions, the new LM–30 rule requires a labor organization ("union") officer or employee ("official") to report *bona fide* loans, interest or dividends that he or she receives from a credit union in which his or her union "is interested." General Instructions for "Form LM–30 Labor Organization Officer and Employee Report" ("Instructions") at 5. An official's union "is interested" in a credit union if it either "created or established" the credit union or "selected or appointed" one or more of its directors AND "a primary purpose" of the credit union is to benefit the union's members. Instructions at 13; 29 C.F.R. 404.1(j) (2008); 72 FR 36106, 36118, 36158 (July 2, 2007).

Our research indicates that sponsoring unions have a dominating "interest" in a minimal proportion of all insured credit unions. To date, there are 63 union-sponsored insured credit unions (according to their names), which are generally quite small in terms of asset size. Of those, the sponsoring union can arguably be credited with having "created or established" the credit union only when the union is its sole sponsor (*i.e.*, has a single common bond of association among the sponsor's members). Similarly, the credit union can arguably be credited with having "a primary purpose" of benefiting the sponsoring union's members only when the union is the credit union's sole sponsor. In either case, credit union directors are never "selected or appointed" by a sponsor; they are elected by the membership. The small asset size of union-sponsored credit unions suggests that the majority of union-sponsored credit unions are each sponsored by a single union that may have a dominating "interest" in the credit union.

The new LM–30 rule imposes a further reporting requirement when the source of loans, interest or dividends received by a union official is a "business" that transacts business with a union or a unionized firm. The LM–30 Instruction defines a "business" entity as a "vendor of goods or provider of services" regardless whether it "employs employees or otherwise meets the definition of 'employer'." Assuming a credit union in which a union has an interest meets this definition of a "business," a union official who is required to report credit union loans dividends and interest also must determine and report whether: (1) Ten percent or more of the credit union's business consists of buying or selling or otherwise dealing with an employer whose employees are represented by the official's union; or (2) Any part of the credit union's business consists of buying, selling or otherwise dealing with the official's union or a trust in which union has an interest.

It is conceivable that a credit union would make loans, pay dividends on deposits or sell services to, or lease space from, an entity whose own employees are represented by the official's union, the sponsoring union itself, or to a pension trust controlled by the union. In these instances, a union official would be subject to the burden of collecting information from his or her credit union, and reporting, about the type and extent of these transactions. As our answers below suggest, it would be far more practical and efficient for the Department of Labor to assume responsibility for collecting information about a credit union's dealings with unions and unionized firms, instead of imposing that burden on union officials who generally are not privy to that information.

Q.7. Given your agency's expertise in the regulation and practices of banks, do you believe that banks are able—and willing—to inform their customers whether they do business with particular unions and how much of their "business" and "business receipts" are with particular unionized firms?

(The questions were framed in reference to banks; our answers refer to credit unions.)

A.7. Credit unions may be willing to identify unions, and firms they know to be unionized, with whom they do business depending on the type of business. If the business between a credit union and a union or unionized firm consists of the union's or firm's member account activity (e.g., loans, deposits), a credit union would not be authorized to disclose that information to anyone but the union's or firm's authorized representative of record. If the business between a credit union and a union or unionized firm consists of the credit union's purchase of goods or services from such a firm or the leasing of space from such union, a credit union would be permitted to disclose that information to a member upon request, but may not be identified by vendor.

Q.8. Are banks obligated or prohibited by any federal or state law to disclose to their customers how much "business" or "business receipts" they have with particular unionized' firms? Can banks simply refuse to answer written inquiries?

A.8. NCUA is not aware of any Federal law that prohibits insured credit unions from disclosing member account information. However, Article XVI, section 2, of the Federal Credit Union Standard By-Laws requires credit union officials to "hold in confidence all transactions . . . with its members and all information respecting their personal affairs, except when permitted by state or federal law." No federal law authorizes credit unions to provide a union official who is a credit union member information about the type and extent of business between the credit union and its union sponsor or a unionized firm. A credit union that would disclose such information without authorization risks developing an unwanted reputation for not holding member financial information in confidence.

Q.9. What type of administrative burden will this LM–30 rule, and the hundreds of thousands of resulting inquiries, place on banks and banks currently prepared to respond to these inquiries?

A.9. The administrative burden on credit unions of retrieving responsive information and responding to inquiries will depend on a particular credit union's human and technological resources. A credit union that well-staffed and whose automated recordkeeping system is sophisticated will be equipped to respond in a timely fashion. The relatively small asset size of union-sponsored credit unions suggests that they would have minimal resources to devote to fielding members' inquiries about the type and extent of the credit union's business with unions and unionized firms.

Q.10. If banks don't provide this non-public information, is there any "information reasonably available" to the public that union officers, employees, and members could use to make good faith estimates?

A.10. Generalized financial data about the type and extent of credit union business dealings is available to a credit union's members from its financial statement, annual report and quarterly Call Reports. However, this data is unsuitable for making "good faith estimates" of credit union's business with unions and unionized firms (accounts, transactions, etc.) because it does not distinguish the type and extent of business transacted with such unions and firms.

DATA ON LOAN MODIFICATION

Q.11. Please provide comprehensive data on mortgage delinquencies, foreclosures, repayment plans and modifications for the mortgages being serviced by the institutions you regulate for the past 12 months. Please provide this information by the following loan categories: subprime, Alt-A, and prime. Please describe the types of repayment plans and modifications that servicers are employing and the numbers of loans in each category.

A.11. Credit union mortgage delinquency and foreclosures increased in 2007, but the results are consistently stronger than the overall mortgage industry performance. Below is the data on mortgage delinquencies for Federal Credit Unions.

	12/31/2006	12/31/2007
1st mortgage fixed rate delinquency	0.25%	0.43%
1st mortgage adjustable rate delinquency	0.23%	0.46%
Other real estate fixed rate delinquency	0.29%	0.59%
Other real estate adjustable rate delinquency	0.34%	0.78%
1st mortgage loan net loss ratio	0.02%	0.02%
Other real estate net loss ratio	0.06%	0.17%
Foreclosed real estate outstanding on balance sheet and % of outstanding RE Loans	$75,008,594 0.06%	$162,688,249 0.11%

Below is the data on mortgage delinquencies for all Federally Insured Credit Unions, including federally-insured state-chartered credit unions who NCUA insures, but where primary regulatory responsibility lies with the state regulator.

	12/31/2006	12/31/2007
1st mortgage fixed rate delinquency	0.28%	0.48%
1st mortgage adjustable rate delinquency	0.33%	0.69%
Other real estate fixed rate delinquency	0.28%	0.67%
Other real estate adjustable rate delinquency	0.36%	0.80%
1st mortgage loan net loss ratio	0.02%	0.02%
Other real estate net loss ratio	0.06%	0.19%
Foreclosed real estate outstanding on balance sheet and % of outstanding RE Loans	$164,121,956 0.07%	$331,862,670 0.12%

NCUA does not gather information regarding repayment plans or modifications for mortgages serviced by credit unions, or categorize mortgage loans by subprime, Alt-A, or Prime. NCUA is presently reviewing the mortgage and other lending data we gather and are considering making changes to gather additional information as appropriate.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM JOANN M. JOHNSON

Q.1. Although not all the items that you suggested were included in this package and there might need to be a few tweaks, are there any items in this package that your agency cannot support or are these all items that would increase regulatory efficiency without compromising safety and soundness and important consumer protections?

A.1. The credit union-related items contained in the regulatory relief amendment referenced are appropriate and would be subject to NCUA regulatory and supervisory oversight if enacted into law.

Q.2. Since all of these items have been vetted and reviewed in past hearings before the banking committee, is there any reason to not move quickly forward with a package along these lines?

A.2. NCUA supports the prompt passage of the regulatory relief amendment contemplated by Senator Crapo.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM DONALD L. KOHN

ANTI-UNION REGULATION

Last year, the Department of Labor issued a regulation drastically expanding the personal financial information union officers and employees must submit to the Department. The new LM–30 rule will require more than 150,000 union volunteers, employees, and their families to report the terms of mortgages, car loans, and even student loans. To determine whether they must report such interests, these individuals must ascertain (1) whether the bank providing a loan does any business with the person's union, or (2) whether the bank does 10 percent of its business with firms whose employees are in the same union. The regulation requires individuals to write to banks asking for this info, and, then, if banks won't provide such information, to contact the Department of Labor for assistance. In the meantime, individuals are required to make good faith estimates of the bank's business with their unions and unionized firms.

Q.1. Given your agency's expertise in the regulation and practices of banks, do you believe that banks are able—and willing—to inform their customers whether they do business with particular unions and how much of their "business" and "business receipts" are with particular unionized firms?

A.1. Pursuant to section 326 of the USA PATRIOT Act, all banks are required to have and maintain a written customer identification program (CIP) that is designed to allow the bank to form a reasonable belief as to the true identity of the bank's customers. See 31 U.S.C. 5318(1); 12 C.F.R. 208.63(b)(2). In addition, banks often track the type and amount of business relationships they have with particular individuals or businesses for their own business or risk-management purposes or for supervisory purposes (*e.g.*, to monitor the amount of "covered transactions" with affiliates to ensure compliance with section 23A of the Federal Reserve Act, 12 U.S.C. 371c).

Banks should be able to identify whether they have a customer relationship with a particular union, union member or business entity. It is unlikely, however, that a bank would have reason to know what (if any) labor organizations represent the employees of an unaffiliated business customer.

Typically, banks consider both the identity of their customers and the amount of business they receive from particular customers as confidential and proprietary. The federal securities laws, however, require a publicly traded company to disclose in its annual report on Form 10–K the name of any customer if (i) sales to the customer represent 10 percent or more of the public company's consolidated revenues, and (ii) the loss of the customer would have a material adverse effect on the public company and its subsidiaries taken as a whole. See SEC Form 10–K, Part I, Item 1; Regulation S-K, 17 C.F.R. 229.101. Thus, if a bank is, or is part of, a publicly traded company and its relationships with a particular firm (whether unionized or not) met these thresholds, the bank or its parent company would have to disclose the name of the firm and its relationships with the bank or parent company in its annual filing with the Securities and Exchange Commission.

Q.2. Are banks obligated or prohibited by any federal or state law to disclose to their customers how much "business" or "business receipts" they have with particular unionized firms?

A.2. Other than the provisions of the federal securities laws noted above, I am not aware of any federal law that would as a general matter obligate or prohibit a bank from disclosing to a union official the amount of business that the bank receives from a particular business entity. For example, the privacy provisions of the Gramm-Leach-Bliley Act would not apply in the situation you describe because a unionized firm likely would not be a "consumer" for purposes of these provisions. See 12 C.F.R. 216.3(e)(1) (defining a "consumer" as an individual who has obtained a financial product or service for personal, household or family purposes). Similarly, the Right to Financial Privacy Act (12 U.S.C. 3401 et seq.) applies only to the provision of financial information to the U.S. government regarding individuals or partnerships comprised of five or few individuals. See 12 U.S.C. 3401(4) and (5). I understand that the Department of Labor's Form LM–30 and related rules also do not obligate a bank to disclose to a union official the amount of business the bank has with a unionized firm.

The terms of a bank's agreement with a customer or applicable state law may restrict the ability of a bank to disclose information about a particular customer's business with the bank to another customer.

Q.3. What type of administrative burden will this LM–30 rule, and the hundreds of thousands of resulting inquiries, place on banks and are banks currently prepared to respond to these inquiries?

A.3. The revised Form LM–30 was adopted by the Department of Labor in August 2007, and a covered individual is required to file the revised Form LM–30 for any fiscal year of the individual that begins on or after August 16, 2007. Because many covered individuals use the calendar year as their fiscal year, many individuals will not have to file a revised Form LM–30 until after December

31, 2008. Accordingly, it is too soon to tell how many inquiries banks may receive related to the revised form and the ability of banks to handle these inquiries.

Q.4. If banks don't provide this non-public information, is there any "information reasonably available" to the public that union officers, employees, and members could use to make good faith estimates?

A.4. As noted above, the federal securities laws require public companies to annually disclose the name of any customer if sales to the customer represent 10 percent or more of the public company's consolidated revenues and the loss of the customer would have a material adverse effect on the public company and its subsidiaries taken as a whole.

COMMERCIAL REAL ESTATE

In December 2006, three agencies, the FRB, OCC and FDIC, issued final guidance highlighting the risks to banks from concentrations in commercial real estate. In issuing the guidance, the regulators specifically emphasized that they were not setting any limits on banks' commercial real estate lending. Yet now we understand from the Comptroller of the Currency and the Chair of the FDIC that over a third of community banks have commercial real estate concentrations exceeding 300 percent of their capital.

Q.5. Are any community banks going to fail because of their overexposure to commercial real estate, including commercial real estate mortgage backed securities?

A.5. On the whole, community banks entered the current period of financial stress with strong capital ratios. Moreover, most community banks maintain manageable exposures to commercial real estate and continue to perform well. However, some institutions have recently begun to face financial difficulties related to overexposure to commercial real estate. These difficulties could be exacerbated by weakening economic fundamentals and deterioration of the commercial real estate market and a very small number of these banks will likely fail. However, while it appears that we may be entering a period when we could experience a higher level of bank failures than we have seen in the recent past, it is important to note that an increase in the rate of failures from its historically low level would not call into question the fundamental safety and soundness of the overwhelming majority of community banks.

Q.6. Was it the correct policy not to set concentration limits in the guidance?

A.6. I believe it was correct. Numerical limits could deprive creditworthy borrowers of loans and banks of sound and profitable lending opportunities. Further, they can provide banks a false sense of security that inhibits appropriate risk management activities when their concentrations fall below the stated limits. For supervisors, the issue was whether banks' risk management practices were adequate to manage the CRE concentration risks. As past market cycles have shown, banks with high CRE concentrations that have strong risk management practices are better prepared to respond to deterioration in market conditions, minimizing their losses.

The primary message of the CRE concentration guidance was a reminder to banks on the importance of sound risk management practices when a bank has a CRE concentration or is growing its CRE lending activity. While the guidance contained broad numeric screens to identify banks with potential CRE concentration risk, the criteria is not viewed as a safe harbor. There may be instances when a bank's risk management systems will be identified for further supervisory analysis when concentration levels are below the criteria, based on factors such as weaknesses in CRE loan underwriting, concentrations in specific CRE lending activity or geographic markets, or rapid growth. Indeed, the risk profile of banks identified with CRE concentrations can differ substantially depending on the bank's specific risk management practices. Therefore, the intent of the screens is to encourage a dialogue between the examiners and an institution's management about the level and nature of CRE concentration risk. The absence of a specific limit or limits on CRE lending does not present a barrier to our examiners in addressing CRE concentration risk at a particular bank.

Q.7. What are examiners doing when they find these levels of concentrations?

A.7. Examiners review a bank's CRE concentration from a risk-focused perspective. In evaluating the presence of any CRE concentration risk, examiners review the bank's CRE portfolio, considering diversification across property types, geographic dispersion, underwriting standards, level of pre-sold or other types of take-out commitments on construction loans, and liquidity.

An examiner will assess the effectiveness of a bank's risk management practices, including: strategic plans, board and management oversight, lending policies, credit administration, market analysis, management information systems and reports, and portfolio level analyses (e.g., stress testing and scenario analysis). To support the overall assessment of a bank's CRE lending activity and loan portfolio, examiners perform transaction level testing of individual credits and identify any specific weaknesses in underwriting practices. When weaknesses are identified, we expect the bank to improve its risk management practices as discussed in the CRE concentration guidance and we will monitor the bank's progress for addressing weaknesses.

Board and Reserve Bank staff have identified and are closely monitoring state member banks at risk for deterioration due to CRE exposures and concentration levels. Based on this priority, examiners will be conducting targeted, on-site reviews of the bank's CRE loan portfolio, the adequacy of loan loss reserves, and an assessment of the bank's reliance on CRE lending for revenue and future earnings. Supervision staff is also enhancing the off-site monitoring of banks with high CRE concentrations, particularly those banks that experienced a recent supervisory rating downgrade. Finally, the Federal Reserve has been conducting specific examiner training on the CRE concentration guidance at each Reserve Bank, focusing on the key elements of sound risk management practices and prudent underwriting practices for CRE lending.

Q.8. What off-balance sheet vehicles are banks using to invest in commercial real estate? Are the regulators approving these kinds of transactions?

A.8. With reference to commercial real estate activity, large institutions are primarily using off-balance sheet vehicles to structure and distribute commercial mortgage backed securities (CMBS), not to make investments. Investments in CMBS and retained securitization exposures are typically held on balance sheet. CMBS issuance in the market grew substantially in the past several years as institutions made greater use of the "originate-to-distribute" business model. The 2007 U.S. CMBS issuance of approximately $200 billion closely matched 2006 activity, despite a substantial drop in volume in the second half of the year. This year, the volume of U.S. CMBS issuance has declined significantly as investors have become much more cautious.

Examiners do not approve specific CMBS transactions, but they do closely monitor regulated institutions' CMBS risk management practices in order to assess their ability to manage the risks associated with both issuances and investments. The sophistication of an institution's CMBS risk management practices should be commensurate with the nature and volume of its activity. An institution with significant CMBS activity would be expected to have a comprehensive, formal strategy for managing risks, including contingency plans to respond to a reduced market demand that might make it difficult to securitize loans being warehoused on the bank's balance sheet. Currently, Federal Reserve examiners are reviewing the pricing and valuation processes of several large institutions to ascertain whether their processes are in line with our safety and soundness expectations. Given the current market turbulence, some of these assets have become more difficult to value precisely, but preliminary observations suggest that institutions have been diligent in fairly valuing these securities.

DISCOUNT WINDOW

Governor Kohn at the hearing on March 4th, I asked you about your thoughts on opening the Fed's discount window lending to non-banks. You responded: "So Congress saw this as an emergency very, very unusual situation that they did not want us using. I would be very cautious about opening that window up more generally. I think the banks have access to the discount window but the quid pro quo, in some sense, or the control—there is a moral hazard issue here, having them have access. And the control on that is this panel, right? You have an extensive amount of bank examination supervision. You have constricted their activities in a number of ways relative to investment banks. I do not think that liquidity is the problem for the investment banks, or liquidity is the issue behind restarting these markets right now."

In the subsequent weeks, one major investment bank failed due to liquidity problems and the Federal Reserve Board of Governors voted to authorize lending from the discount window to investment banks.

Q.9. Vice-Chairman Kohn, in light of the recent facts, can you explain your answer that liquidity was not the problem for investment banks? Further, can you please inform the Committee what, if any, supervisory measures the Board has implemented with respect to investment banks' ability to access the discount window? What additional measures would be appropriate, and does the Board need additional authority to implement such measures?

A.9. When I testified on March 4, financial markets were severely strained and liquidity pressures were clearly evident in uncollateralized wholesale funding markets. Nonetheless, investment banks had been able to manage reasonably well to that point, largely because they relied heavily on secured funding against high quality collateral in repo markets. Historically, borrowing against high quality collateral in the repo market has been a stable and reliable funding source for investment banks and other financial firms. In mid-March, however, these markets came under intense pressure as lenders came to question the value of collateral they were accepting in repo transactions and also became very concerned about counterparty credit risk. Many lenders applied higher haircuts on the collateral taken in repo transactions, and pulled back from lending to particular counterparties altogether. In response to these unusual and exigent circumstances, the Federal Reserve exercised the emergency authorities I discussed with you at the hearing to establish two facilities—the Primary Dealer Credit Facility (PDCF) and the Term Securities Lending Facility (TSLF)-aimed at supporting the liquidity of primary dealers and, indirectly, the liquidity of the broader financial markets. In addition, the Federal Reserve judged it appropriate to provide funding to Bear Stearns to prevent a disorderly failure that likely would have had significantly adverse consequences for our financial system and economy.

All the primary dealers eligible to borrow from the Federal Reserve under the PDCF or to transact with the Federal Reserve under the TSLF are subject to supervision and regulation by the SEC. In addition, the parent companies of nearly all of these primary dealers are subject to consolidated supervision—either by the Federal Reserve in the case of dealers that are owned by a U.S. bank holding company, a foreign bank supervisory agency in the case of dealers that are owned by a foreign bank, or the SEC in the case of dealers that are not affiliated with banks. While the special lending facilities for primary dealers are in place, the Federal Reserve is working closely with the SEC to ensure that we have access to necessary supervisory information, and this coordination has been very effective.

Q.10. Vice-Chairman Kohn, you also said: "I do not think opening up credit to the investment banks will really be that helpful in the end and could carry some very major costs." You subsequently voted to do just that. Can you please explain whether the Fed's action was helpful in the end? What costs came along with the action? And how is the Fed making sure that the taxpayer will not bear any costs associated with any of the Fed's recent actions?

A.10. The Federal Reserve's actions were essential to avert a financial crisis that likely would have had serious repercussions for the U.S. economy. Had Bear Stearns defaulted on its obligations, already disrupted financial markets would have been thrown into further turmoil, prices in key markets would have been affected as counterparties scrambled to lower risk, and the viability of other dealers would have been called into question. The actions we took do have the potential to exacerbate moral hazard; that is, that the incentives for primary dealers and their investors to effectively manage their liquidity risks could be weakened to the extent that they expect the Federal Reserve to establish emergency lending facilities in any future financial crisis. Although the potential for moral hazard should be carefully analyzed and considered by policymakers, it seems more likely that the example of Bear Stearns—in which shareholders and management suffered considerable losses—and the broader distress in financial markets will serve as a potent reminder to primary dealers and other leveraged market participants about the importance of prudent liquidity risk management. In particular, in developing their liquidity management plans, primary dealers and others must now attach considerable weight to scenarios in which their access to funding in the repo market is sharply curtailed. Of course, the Federal Reserve, the SEC, and other regulatory agencies will be working to reinforce that message.

As to the potential for taxpayer losses associated with the Federal Reserve's recent actions, all credit extended to primary dealers under the PDCF and all transactions with primary dealers under the TSLF are fully secured by investment-grade securities with ample haircuts applied to market valuations. In addition, the March 14 loan to Bear Stearns was repaid on March 17 without loss to the taxpayer. There are also substantial protections for taxpayers associated with the prospective $29 billion extension of credit by the Federal Reserve to be made in connection with the acquisition of Bear Stearns by JPMorgan Chase & Co. The collateral for the loan will be in the form of investment-grade securities and performing credit facilities, JPMorgan Chase will bear the first $1 billion of losses on the collateral pool, the Federal Reserve will be able to liquidate the collateral over a long-term horizon, and we have hired a professional independent investment adviser to manage the collateral pool so as to maximize the returns to the Federal Reserve and the taxpayer.

BASEL II

There was extensive conversation on what would have been the capital status of banks going into this crisis period had Basel II capital standards been in effect. Fed Vice-Chairman Kohn said that if, "we had the same safeguards in place, and if we started implementing in 2004 with the same safeguards that are in place in 2008 and 2009, I do think on balance we would have been better off." Mr. Gronstal answered differently, stating: "I think the answer to your second question is that we probably would have had lower dollar amounts of capital per asset, and that makes it more challenging to deal with issues when times get rough."

Q.11. Can you explain in writing, whether you believe that banks would have had more or less capital in place for this current down turn had Basel II been implemented during the time frame that Vice-Chairman Kohn mentioned in his response? Can you also explain why you believe that to be the case, citing any empirical data on both the effects of Basel II on capital requirements and what we have experienced during this economic crisis, as it relates to assets?

A.11. The Basel II framework is designed to more closely align regulatory capital requirements with actual risks and to further strengthen banking organizations' risk-management practices. While it is difficult to quantify the level of capital banks would have had in place in 2007 if they had implemented Basel II in 2004, Basel II implementation would have placed banks in a stronger position by requiring them to institute more robust risk management practices that kept pace with changes in financial markets and business models. The system and infrastructure requirements under Basel II may have provided banks better and timelier access to important data as well as to validated measures of risk.

The Basel II framework requires banks to develop robust data series on defaults, losses and recoveries that include an economic downturn. These data inputs are filtered through a prudential capital framework specified by supervisors, and which requires consideration of how exposures will perform during economic downturn conditions. This will induce a major upgrade in banks' risk management systems which, had these enhancements been achieved before the crisis, would have helped put banks on a more sound footing. Banks will only be able to use their internal measures of risk for regulatory capital requirements after rigorous supervisory review; the use of transitional safeguards during the first years of Basel II implementation will help ensure there are no sudden drops in capital levels and that bank inputs are robust.

In addition, Basel II reduces incentives for regulatory capital arbitrage and includes enhanced public disclosure requirements. The greater transparency provided by the disclosure requirements creates more opportunities for market discipline to foster best practices in the banking industry. Banks also are required to assess the capital needed to support their overall risk profiles including liquidity and reputational risk which have been significant in the current turmoil. Taken together, the three pillars of Basel II (minimum capital, risk management and supervisory oversight, and market transparency) strengthen capital regulation by providing multiple perspectives on banks' risk and the adequacy of their capital cushions.

Q.12. During the discussion of Basel II, Comptroller Dugan told the Committee: "The irony of this whole situation is that the very high—most highly rated best securities, the ones that were thought to be least likely to default was where all the—a huge share of the losses have been concentrated." Given Basel II's reliance on ratings of securities, does this observation give you reason for concern over the current Basel II structure? If so, what do you recommend be done; if not, why not?

A.12. The Basel Committee has committed to adjust the Basel II capital requirements in light of recent market events. Specifically, the Basel Committee is, among other things, revising the capital treatments for re-securitizations, liquidity facilities to ABCP conduits, CDO securities, and securitizations in the trading book, as well as for default and event risk. The Federal Reserve strongly supports and is actively participating in reassessment of the regulatory capital requirements for securitization exposures under the Basel II framework and making any adjustments that may be appropriate. Consistent with the recommendations of the President's Working Group on Financial Markets, U.S. authorities are also reviewing their use of credit ratings in regulations.

TOO BIG TO FAIL

Q.13. I am concerned about the potential ramifications of the failure of a very large institution. Is your agency prepared today to handle the failure of a large systemically significant insured financial institution? What steps are you taking to prepare for this contingency?

A.13. For several years, the Federal Reserve has been working closely with the FDIC and other relevant supervisors to examine and understand the issues that would be associated with the resolution of a large insured bank, and to explore options for resolving these issues to prepare for such a contingency. These efforts have involved, among other things, numerous meetings and exchanges of information with the FDIC as well as with the Department of the Treasury, including the OCC and OTS. These discussions have focused on how a least cost resolution could be implemented for a large insured bank, and how moral hazard could be minimized if a determination were made, in accordance with the requirements of the Federal Deposit Insurance Act, to invoke the so-called systemic risk exception to the least cost requirement. In addition, the Federal Reserve has worked with the FDIC and Department of the Treasury to develop a protocol describing the general types of information that would be useful to the agencies in considering whether to recommend that the systemic risk exception be invoked in a particular instance, and we have that protocol in place today. These efforts and others, such as simulation exercises, will continue to enhance the Federal Reserve's contingency planning for the resolution of a large, systemically significant insured bank.

Moreover, the Federal Reserve worked cooperatively with the FDIC, OCC and OTS to develop a new memorandum of understanding describing the situations under which the FDIC would have access to information at an insured depository institution prior to failure to facilitate appropriate contingency planning and prepare for the possible processing of deposit insurance claims. To further improve the FDIC's ability to plan for and handle a large bank resolution, the Federal Reserve continues to support the FDIC's ongoing rulemaking efforts to address, in advance of a large bank failure, resolutions issues such as streamlining the claims process and clarifying how sweep accounts will be handled in a resolution.

In addition to these domestic efforts, the Federal Reserve has participated on numerous international groups, sponsored by the Basel Committee on Banking Supervision (BCBS), the Financial Stability Forum (FSF), and the Governors of the G–10 central banks, to explore issues related to the failure of a large, internationally active bank.

DATA ON LOAN MODIFICATION

Q.14. Please provide comprehensive data on mortgage delinquencies, foreclosures, repayment plans and modifications for the mortgages being serviced in the institutions you regulate for the past 12 months. Please provide this information by the following loan categories: subprime, Alt-A, and prime. Please describe the types of repayment plans and modifications that servicers are employing and the numbers of loans in each category.

A.14. The Federal Reserve Board (the Board) collects extensive data on mortgages, however, institutions' regulatory filings do not require a breakdown of mortgage exposure based on categories such as prime, subprime, or alt-A. These terms are not uniformly defined across banking organizations. To respond to the question, the Board has compiled information available from its supervisory activities and has surveyed a number of supervised institutions. These institutions are both state member banks and non-bank subsidiaries of bank holding companies, which are not supervised by the other agencies. The institutions were chosen based on the size of their mortgage servicing portfolios, with the nine largest servicers selected. Together, these institutions' servicing portfolios represent a significant portion of mortgage loans serviced by entities directly supervised by the Federal Reserve. The data have been provided directly from supervised institutions without examiner validation and should be used for informational purposes only.

Discussion of loss mitigation strategies

The surveyed lenders employ a range of loss mitigation strategies including modifications, repayment plans, forbearance agreements, deed-in-lieu transactions, and short sales. Below is a brief discussion of each of these strategies, as described by the surveyed lenders.

- Modification plans change the terms of the note, including reducing the interest rate, conversion from an adjustable rate to a fixed rate, deferring payments, waiving a portion of the amount due, capitalization of past due amounts, or extension of the maturity date. Lenders provide both permanent and temporary modifications depending on specific borrower circumstances. A temporary modification can be made permanent at any time if the situation changes. Approval is usually subject to verification of income, assets and liabilities. Lenders report that the verification process is typically the most time consuming part of helping troubled borrowers. Upon receipt of the appropriate verifications, modifications are usually processed in about two weeks.
- Repayment plans are often employed when it is necessary for the customer to demonstrate the willingness and ability to pay a reduced amount after a period of sporadic payment history prior to completion of a more permanent modification. These types of repayment plans are generally less formal in nature in anticipation of a more formal written modification.

- Forbearance agreements are generally drafted after a foreclosure action has commenced and have specific terms and timeframes.
- Deed-in-lieu of foreclosures and short sales terminate the borrower's ownership of the property without the expense and time consumption of a formal foreclosure process and are negotiated transactions between the borrower and the lender. In a deed-in-lieu of foreclosure, the borrower turns over the deed to the lender. Settlement terms for any deficiency amount are negotiated on a case-by-case basis. In a short sale transaction, the borrower agrees to sell the property to a third party but the proceeds are not sufficient to fully repay the debt and settlement of any unpaid balance is negotiated on a case-by-case basis.

Discussion of the data

The surveyed institutions were asked to provide information using defined credit score ranges. These ranges are believed to be consistent with those used by the other agencies in their response to this request and are consistent with the loan modification reporting standards used by the HOPE NOW alliance and other data collection services. The lenders who participated in the survey provided data for the six month period beginning October 2007 and ending March 2008. The lenders reported servicing more than $400 billion of loans to over 3.3 million borrowers. During the survey period, the dollar amount of loans originated with credit scores less than 620, as well as loans originated with credit scores between 620 and 660, each represented about 10 percent of the total dollar volume of surveyed loans. Loans originated with credit scores greater than 660 represented over two thirds of the portfolio, and the remaining amount was originated using a methodology other than a reported credit score. The attached tables present the data provided by the lenders and detail information by both dollar amount and by number of borrowers. As mentioned, the tables are further segmented by credit score and provide detailed information, by month, on current loans, delinquent loans, and foreclosure starts, as well as information on loss mitigation and loan modification activities.

Unpaid Principal Balance - All Loans

	October	November	December	January	February	March
Current Loans	$387,161,183,494	$391,029,992,159	$383,058,342,500	$384,136,951,500	$385,939,929,711	$386,550,949,634
Loans 30-59 days past due excluding foreclosures	9,799,742,250	10,407,172,674	10,912,250,054	10,916,193,014	10,671,748,028	10,231,164,480
Loans 60 days or more past due excluding foreclosures	7,203,310,895	7,898,374,737	8,855,718,985	9,275,009,910	9,316,513,593	9,533,278,481
Foreclosures Initiated	2,637,324,810	2,953,300,800	3,249,825,579	3,595,846,834	3,902,784,967	4,050,362,352
Loss Mitigation Activities - Newly initiated, but not yet completed during the month[1]	$1,505,562,866	$1,848,960,361	$1,165,406,365	$1,559,146,852	$1,569,195,554	$2,252,743,101
Loss Mitigation Activities - Completed during the month	1,943,090,343	2,023,569,204	2,007,452,354	2,207,316,938	2,230,656,308	2,308,249,873
Permanent Loan Modification Activities - Completed during the month	1,090,132,886	1,194,106,600	1,158,613,123	1,242,799,170	1,218,671,671	1,241,810,498

[1] *One lender only reported newly initiated loss mitigation activities for the months of October and November.*

Unpaid Principal Balance - FICO Band < 620

	October	November	December	January	February	March
Current Loans	$38,777,794,273	$38,431,950,663	$37,859,651,052	$37,664,094,413	$37,674,853,084	$37,475,361,974
Loans 30-59 days past due excluding foreclosures	3,456,207,857	3,525,345,268	3,937,700,086	3,985,587,925	3,666,057,742	3,554,949,204
Loans 60 days or more past due excluding foreclosures	2,732,717,251	2,821,358,963	3,367,243,961	3,484,527,389	3,422,763,815	3,506,518,119
Foreclosures Initiated	562,240,207	587,827,413	594,071,048	689,264,829	709,227,296	646,116,657
Loss Mitigation Activities - Newly initiated, but not yet completed during the month[1]	$478,042,342	$560,373,366	$432,381,487	$656,036,596	$672,170,836	$1,048,140,672
Loss Mitigation Activities - Completed during the month	996,330,593	1,056,013,256	1,021,725,330	1,134,096,087	1,135,503,529	1,178,129,086
Permanent Loan Modification Activities - Completed during the month	603,905,112	663,911,517	634,012,186	666,260,501	653,095,319	654,977,310

[1] *One lender only reported newly initiated loss mitigation activities for the months of October and November.*

Unpaid Principal Balance - FICO Band 620 - 659

	October	November	December	January	February	March
Current Loans	$37,360,048,911	$37,092,373,445	$36,052,153,189	$36,032,876,681	$35,884,560,993	$35,430,288,738
Loans 30-59 days past due excluding foreclosures	1,929,871,330	2,055,359,623	2,108,762,268	2,152,029,175	2,045,927,093	1,921,654,403
Loans 60 days or more past due excluding foreclosures	1,282,933,574	1,414,115,021	1,592,139,895	1,685,197,543	1,667,003,056	1,650,623,662
Foreclosures Initiated	569,333,246	648,753,325	729,086,460	799,596,610	851,552,982	831,744,306
Loss Mitigation Activities - Newly initiated, but not yet completed during the month[1]	$313,148,372	$401,131,513	$247,702,351	$370,837,038	$351,117,162	$498,289,241
Loss Mitigation Activities - Completed during the month	482,909,109	503,629,617	480,482,991	529,661,834	547,938,378	556,584,070
Permanent Loan Modification Activities - Completed during the month	244,615,604	271,959,427	252,028,890	262,213,621	267,593,709	278,172,149

[1] *One lender only reported newly initiated loss mitigation activities for the months of October and November.*

Unpaid Principal Balance - FICO Band > 660

	October	November	December	January	February	March
Current Loans	$264,574,411,489	$266,352,929,176	$262,028,007,337	$264,077,826,784	$265,819,810,073	$263,770,096,642
Loans 30-59 days past due excluding foreclosures	2,754,302,531	3,041,158,372	3,077,430,932	2,977,802,554	3,237,132,501	3,049,359,516
Loans 60 days or more past due excluding foreclosures	2,017,581,237	2,385,289,140	2,595,637,337	2,788,712,947	2,918,857,664	3,008,710,811
Foreclosures Initiated	1,366,230,328	1,536,556,356	1,756,160,384	1,925,417,081	2,147,073,820	2,216,133,440
Loss Mitigation Activities - Newly initiated, but not yet completed during the month[1]	$464,628,252	$606,398,725	$246,545,837	$399,959,088	$418,427,845	$570,806,703
Loss Mitigation Activities - Completed during the month	342,788,703	342,297,552	361,841,045	418,337,284	405,992,992	433,789,647
Permanent Loan Modification Activities - Completed during the month	161,671,972	174,081,817	175,378,547	219,780,321	208,242,121	208,202,193

[1] *One lender only reported newly initiated loss mitigation activities for the months of October and November.*

Unpaid Principal Balance - FICO Band Not Available

	October	November	December	January	February	March
Current Loans	$46,448,928,822	$49,152,738,875	$47,118,530,922	$46,362,153,622	$46,560,705,561	$49,875,202,280
Loans 30-59 days past due excluding foreclosures	1,659,360,532	1,785,309,411	1,788,356,767	1,800,773,361	1,722,630,693	1,705,201,356
Loans 60 days or more past due excluding foreclosures	1,170,078,833	1,277,611,614	1,300,697,792	1,316,572,032	1,307,889,058	1,367,425,889
Foreclosures Initiated	139,521,028	180,163,707	170,507,687	181,568,315	194,930,869	356,367,950
Loss Mitigation Activities - Newly initiated, but not yet completed during the month[1]	$249,743,899	$281,056,757	$238,776,690	$132,314,130	$127,479,710	$135,506,485
Loss Mitigation Activities - Completed during the month	121,061,939	121,628,779	143,402,987	125,221,733	141,221,410	139,747,070
Permanent Loan Modification Activities - Completed during the month	79,940,198	84,153,839	97,193,500	94,544,728	89,740,522	100,458,846

[1] *One lender only reported newly initiated loss mitigation activities for the months of October and November.*

Loan Count - All Loans

	October	November	December	January	February	March
Current Loans	3,359,369	3,381,894	3,330,155	3,323,563	3,333,018	3,327,554
Loans 30-59 days past due excluding foreclosures	96,008	87,829	84,298	83,579	79,435	76,484
Loans 60 days or more past due excluding foreclosures	78,064	83,082	68,026	69,733	68,311	68,446
Foreclosures Initiated	21,357	23,253	19,147	20,659	21,989	22,521
Loss Mitigation Activities - Newly initiated, but not yet completed during the month[1]	12,278	14,311	7,766	9,887	9,375	12,438
Loss Mitigation Activities - Completed during the month	13,568	14,092	14,002	15,345	15,456	15,678
Permanent Loan Modification Activities - Completed during the month	7,845	8,562	8,300	8,800	8,482	8,421

[1] *One lender only reported newly initiated loss mitigation activities for the months of October and November.*

Loan Count - FICO Band < 620

	October	November	December	January	February	March
Current Loans	312,650	310,414	305,375	305,743	307,058	305,218
Loans 30-59 days past due excluding foreclosures	27,261	27,312	29,914	30,013	27,010	26,388
Loans 60 days or more past due excluding foreclosures	24,454	25,405	23,848	24,437	23,355	23,177
Foreclosures Initiated	5,523	5,774	5,001	5,539	5,541	5,150
Loss Mitigation Activities - Newly initiated, but not yet completed during the month[1]	3,380	3,922	2,541	3,979	3,809	5,657
Loss Mitigation Activities - Completed during the month	7,276	7,634	7,419	8,222	8,186	8,398
Permanent Loan Modification Activities - Completed during the month	4,394	4,839	4,524	4,771	4,623	4,633

[1] *One lender only reported newly initiated loss mitigation activities for the months of October and November.*

Loan Count - FICO Band 620 - 659

	October	November	December	January	February	March
Current Loans	299,530	298,098	292,329	293,318	293,010	290,511
Loans 30-59 days past due excluding foreclosures	14,612	14,207	14,186	14,298	13,286	12,622
Loans 60 days or more past due excluding foreclosures	17,833	19,279	10,825	11,204	10,934	10,678
Foreclosures Initiated	4,015	4,418	3,800	4,163	4,384	4,375
Loss Mitigation Activities - Newly initiated, but not yet completed during the month[1]	2,313	2,797	1,403	2,119	1,943	2,594
Loss Mitigation Activities - Completed during the month	3,012	3,118	3,002	3,360	3,383	3,414
Permanent Loan Modification Activities - Completed during the month	1,610	1,763	1,699	1,766	1,708	1,735

[1] *One lender only reported newly initiated loss mitigation activities for the months of October and November.*

Loan Count - FICO Band > 660

	October	November	December	January	February	March
Current Loans	2,199,194	2,207,512	2,180,843	2,188,243	2,197,321	2,184,859
Loans 30-59 days past due excluding foreclosures	34,622	25,220	20,068	19,365	20,125	18,949
Loans 60 days or more past due excluding foreclosures	15,539	17,458	17,786	18,556	19,016	19,536
Foreclosures Initiated	9,512	10,495	8,457	8,994	10,114	10,386
Loss Mitigation Activities - Newly initiated, but not yet completed during the month[1]	3,445	4,482	1,690	2,325	2,219	2,835
Loss Mitigation Activities - Completed during the month	1,992	2,000	2,125	2,476	2,421	2,481
Permanent Loan Modification Activities - Completed during the month	1,036	1,068	1,146	1,334	1,271	1,146

[1] *One lender only reported newly initiated loss mitigation activities for the months of October and November.*

Loan Count - FICO Band Not Available

	October	November	December	January	February	March
Current Loans	547,995	565,870	551,608	536,259	535,629	546,966
Loans 30-59 days past due excluding foreclosures	19,513	21,090	20,130	19,903	19,014	18,525
Loans 60 days or more past due excluding foreclosures	20,238	20,940	15,567	15,536	15,006	15,055
Foreclosures Initiated	2,307	2,566	1,889	1,963	1,950	2,610
Loss Mitigation Activities - Newly initiated, but not yet completed during the month[1]	3,140	3,110	2,132	1,464	1,404	1,352
Loss Mitigation Activities - Completed during the month	1,288	1,340	1,456	1,287	1,466	1,385
Permanent Loan Modification Activities - Completed during the month	805	892	931	929	880	907

[1] *One lender only reported newly initiated loss mitigation activities for the months of October and November.*

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM DONALD L. KOHN

Q.1. Although not all the items that you suggested were included in this package and there might need to be a few tweaks, are there any items in this package that your agency cannot support or are these all items that would increase regulatory efficiency without compromising safety and soundness and important consumer protections?

A.1. As you know, the Board has worked closely with your office, other members of Congress and supervisors, banking organizations and consumer organizations to develop numerous regulatory relief amendments. Many of the amendments supported by the Board were included in the Financial Services Regulatory Relief Act of 2006 (FSRRA), of which you were a chief sponsor. At your request, the Board in November 2007 also provided you with three new regulatory relief amendments as well as a technical amendment.

One of the Board's priority regulatory relief items which was not enacted as part of FSRRA is included as section 17 of the package you introduced. This amendment would promote efficiency in our financial system by repealing the provisions in current law that prohibit depository institutions from paying interest on demand deposits. The Board continues to strongly support this amendment.

The amendments included in your package also would remove the provisions in FSRRA that delay, until October 1, 2011, the effective date of the amendments in that act that provide the Federal Reserve both the ability to pay interest on balances held by depository institutions at a Reserve Bank and greater flexibility in setting reserve requirements. Having the ability to implement these authorities more promptly if appropriate would be beneficial.

The Board continues to have concerns with the amendment included as section 5, which would raise, from $500 million to $1 billion, the asset threshold below which an insured depository institution may qualify for an extended 18–month examination cycle. The Board has not taken a position on the other amendments included in your package.

Q.2. Since all of these items have been vetted and reviewed in past hearings before the Banking Committee, is there any reason to not move quickly forward with a package along these lines?

A.2. The Board strongly supports efforts by Congress to identify those provisions of the federal banking laws that may be removed or modified without undermining the important public policy goals of financial regulation, including the safety and soundness of banking organizations, financial stability, and consumer protection. The Board and its staff would be pleased to work with you as you and your colleagues move forward in developing appropriate regulatory relief legislation.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM THOMAS B. GRONSTAL

BASEL II QUESTION FOR THE FDIC, FED, OCC, OTS, CSBS

Q.1. There was extensive conversation on what would have been the capital status of banks going into this crisis period had Basel II capital standards been in effect. Fed Vice-Chairman Kohn said that if, "we had the same safeguards in place, and if we started implementing in 2004 with the same safeguards that are in place in 2008 and 2009, I do think on balance we would have been better off." Mr. Gronstal answered differently, stating: "I think the answer to your second question is that we probably would have had lower dollar amounts of capital per asset, and that makes it more challenging to deal with issues when times get rough."

Can each of you explain in writing, whether you believe that banks would have had more or less capital in place for this current down turn, had Basel II been implemented during the time frame that Vice-Chairman Kohn mentioned in his response. Can you also explain why you believe that to be the case, citing any empirical data on both the effects of Basel II on capital requirements and what we have experienced during this economic crisis, as it relates to assets.

During the discussion of Basel II, Comptroller Dugan told the Committee: "The irony of this whole situation is that the very high—most highly rated best securities, the ones that were thought to be least likely to default was where all the—a huge share of the losses have been concentrated." Given Basel II's reliance on ratings of securities, does this observation give you reason for concern over the current Basel II structure? If so, what do you recommend be done; if not, why not?

A.1. The models and assumptions which drive the calculation of capital under Basel II were developed during a period of extraordinary economic growth and asset value appreciation. Given the historic low level of risk for residential mortgage loans, it is highly likely that most models would generate a lower level of required capital. The data from QIS–4 revealed significant declines in minimum required capital for residential mortgages and home equity lines of credit. Obviously, these asset categories have become a tremendous source of loss for the financial system. The only asset category to see an increase in capital allocation in QIS–4 was credit cards. Without the ability to detect and measure soft information impacting credit quality (i.e. changes in underwriting practices), it is likely that Basel II banks would be holding less capital heading into the current economic environment.

Basel II must be re-evaluated in the context of the current market. The current crisis has challenged our long-held assumptions on the safety of residential mortgage loans and the reliance on the judgment of rating agencies. We can and should apply these lessons to other asset categories. One of the lessons learned from this crisis should be the importance and necessity of a minimum leverage ratio as part of our capital rules.

DATA ON LOAN MODIFICATION

Q.2. Please provide comprehensive data on mortgage delinquencies, foreclosures, repayment plans and modifications for the mortgages being serviced by the institutions you regulate for the past 12 months. Please provide this information by the following loan categories: subprime, Alt-A, and prime. Please describe the types of repayment plans and modifications that servicers are employing and the numbers of loans in each category.

A.2. As we discussed in testimony, working through a joint initiative with the state attorneys general, we are collecting loan modification data from 13 subprime servicers. The last report was issued in April. A copy is included as part of our response.

2008

ANALYSIS OF SUBPRIME MORTGAGE SERVICING PERFORMANCE

DATA REPORT NO. 2
APRIL 2008

STATE FORECLOSURE PREVENTION WORKING GROUP

Executive Summary

In February 2008, the State Foreclosure Prevention Working Group published its first data report on performance of subprime mortgage servicing, based on data from October 2007 provided by 13 of the 20 largest subprime mortgage servicers. The State Foreclosure Prevention Working Group, composed of state attorneys general and state banking regulators, published this data to provide the public with information to shed light on how servicers are managing the unprecedented level of homeowners struggling to make their mortgage payments.

The first report found that, while servicers had increased their use of loan modifications, a large percentage of seriously delinquent loans (7 out of 10) were not in any sort of work-out process. The first report also revealed that a significant proportion of adjustable rate subprime loans were entering into delinquency prior to the first reset date, reflecting the extent of weak underwriting and mortgage origination fraud present in subprime loans in recent years.

This second report provides information on servicing performance from October 2007 through and including January 2008. The additional data allow us to assess performance trends, in addition to providing a static snapshot of recent performance.

Based on our analysis, the collective efforts of servicers and government officials to date have not translated into meaningful improvement in foreclosure prevention outcomes. In major respects, the subprime servicing data for January 2008 is nearly *unchanged* from October 2007. In normal times, one would not expect a significant change in a four-month period; however, this time period involved a dramatic increase in public attention to the subprime mortgage crisis, a ramping up of efforts by the HOPE NOW Alliance, and the initiation of new creative outreach efforts by servicers and government officials.

Specific Findings:

1. **Seven out of ten seriously delinquent borrowers are *still* not on track for any loss mitigation outcome.** While the number of borrowers in loss mitigation has increased, it has been matched by an increasing level of delinquent loans. The number of home retention solutions (forbearance, repayment plan, and modification) in process, as compared to the number of seriously-delinquent loans, is unchanged during the four month period. The absolute numbers of loss mitigation efforts and delinquent loans have increased, but the relative percentage between the two has remained the same. Given creative servicer outreach efforts and increased public awareness of the HOPE Hotline during this time period, this large gap suggests a more systemic failure of servicer capacity to work out loans.

2. **Data suggests that loss mitigation departments are severely strained in managing current workload.** For example:

   a. Almost two-thirds of all loss mitigations efforts started are not completed in the following month. Most loss mitigation efforts do not close quickly. This consistent trend over the last three months suggests that many proposed loss mitigations fail to close, rather than simply take longer than a month to work through the system. Based on anecdotal reports of lost paperwork and busy call centers, we are concerned that servicers overall are not able to manage the sheer numbers of delinquent loans.

   b. Seriously delinquent loans are "stacking up" on the way to foreclosure. The primary increases in subprime delinquency rates are occurring in very seriously delinquent loans or in loans starting foreclosure. This suggests that the burgeoning numbers of delinquent loans that do not receive loss mitigation attention are clogging up the system on their way to foreclosure. We fear this will translate to increased levels of vacant foreclosed homes that will further depress property values and increase burdens on government services.

3. **For those homeowners receiving loss mitigation assistance, more are receiving loan modifications**. Two-thirds of home retention solutions started in January were directed to loan modification, showing a continued shift to longer-term solutions for homeowners that receive loss mitigation assistance. Many servicers are replacing their use of repayment plans in favor of loan modifications.

New approaches are needed to prevent millions of unnecessary foreclosures. Without a substantial increase in loss mitigation staffing and resources, we do not believe that outreach and unsupervised case-by-case loan work-outs, as used by servicers now, will prevent a significant number of unnecessary foreclosures. In our first report, we renewed our call for more systematic, long-term solutions to efficiently deal with subprime loans originated in recent years. While we support industry-led efforts to implement broader-based programs such as the ASF "fast track" program and Project Lifeline's 30-day breathing period, we still see a tremendous gap between the need for loan work-outs and the options in place today.

The State Working Group believes more robust approaches to avoid preventable foreclosures are necessary. Servicers, investors, and state officials have opportunities to work together on the following:

- Developing a more systematic loan work-out system to replace the intensive "hands-on" loss mitigation approach. The continued reliance on intensive individual interaction to identify alternatives to foreclosure misses out on opportunities to implement solutions that can reach more homeowners facing foreclosure. A more systematic approach would benefit homeowners and investors by reaching more people with more streamlined solutions. Such an approach would build on the initial effort of the ASF Framework, but cover many more loans.
- Slowing down the foreclosure process to allow for more work-outs. Many states have passed or are considering legislation to slow down the foreclosure process and to increase notice to delinquent homeowners. Targeted efforts to slow down subprime foreclosures may give homeowners and servicers more time to find solutions to avoid foreclosure.

In addition to these efforts, the State Working Group recognizes that federal officials have proposed or are considering legislation, such as permitting judicial modification of loans in bankruptcy and expanding FHA refinancing of subprime loans, that would mark a significant change to the current mortgage servicing dynamics. While we do not endorse any specific federal approach, we support the development of innovative approaches that recognize the extent and scale of the foreclosure crisis.

Updates and Trends between October 2007 and January 2008

Our first report,[1] issued in February 2008, included an extensive discussion of the purposes and formation of the State Foreclosure Prevention Working Group, the development of our "call report" format to collect data from subprime mortgage servicers, and the participation of 13 of the largest 20 subprime servicers.

We also provided a detailed discussion of the first monthly submission of servicing data covering the month of October 2007. This second report will highlight trends between the October 2007 data and the subsequent three months through and including January 2008. As with our first report, we have included as Appendix A the consolidated state report data for the most recent month (in this case, January 31, 2008). We have also included (as Appendix B) a trend analysis to cover each month between October 2007 and January 2008.

A. Summary of Servicing Activity

The composition of the Reporting Servicers did not change from the first report. We continue to have data from 13 of the largest subprime servicers, accounting for approximately 57% of the subprime servicing market. After the first report, several servicers revised data to improve the accuracy of their reporting and understanding of data definitions. With one exception, discussed in Section B below, these revisions did not create a material change from the initial data included in our first report.

Payment Resets
In our first report, we highlighted the high level of delinquency for adjustable rate subprime loans *before* any "reset" of their interest rate to a higher level. The most recent data identifies a worsening of this trend, as more subprime loans are delinquent prior to any payment change. For instance, the percentage of loans facing reset in the 3rd Quarter of 2009 that are currently delinquent jumped from 21.4% to 28.5%. While delinquency rates increase during the early life of a loan pool, this worsening trend confirms our initial assessment that very weak underwriting and mortgage origination fraud, and not simply payment resets, has been the primary cause for elevated subprime loan delinquencies for loans originated through at least the middle of 2007.

While rate resets have a potential to create payment shock, recent cuts in interest rates have somewhat reduced the potential impact of payment shock to accelerate the rate of delinquency and foreclosure.[2] As our first report found, only about 3% of currently delinquent loans entered delinquency as a direct result of an initial payment reset.

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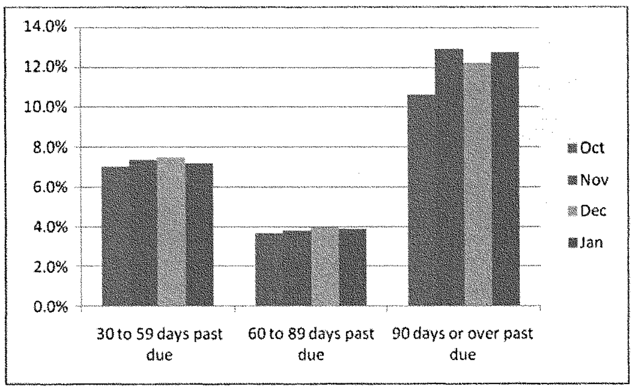
[1] *Analysis of Subprime Mortgage Servicing Performance, Data Report No. 1*, State Foreclosure Prevention Working Group (Feb. 7, 2008), available at http://www.csbs.org/Content/NavigationMenu/Home/StateForeclosurePreventionWorkGroupDataReport.pdf.

[2] *See Fed's Interest Rate Cuts Limit Subprime ARM Reset 'Shock'*, Inside B&C Lending, March 28, 2008 at 6 (referring to S&P report on impact of interest rate cuts on subprime adjustable rate mortgages).

Delinquency and Default

At the end of January 2008, nearly a quarter of subprime and Alt-A loans were reported delinquent. The servicers reported more than 630,000 subprime and Alt-A loans delinquent by 90 days or more. As shown in Figure 1 below, the delinquency rate for 30-day and 60-day delinquencies remained relatively constant, while the 90-day delinquency rate increased by 16%. This conveys that servicers are pushing the 30-day delinquent files to the next category, then the 60-day delinquent files to the 90 days or over category. Unfortunately, this lack of loan delinquency resolution at the first signs of problems for the borrower is only leading to a pile-up of seriously-delinquent files and ultimately, foreclosure.

Figure 1. Subprime and Alt-A Delinquency Rates



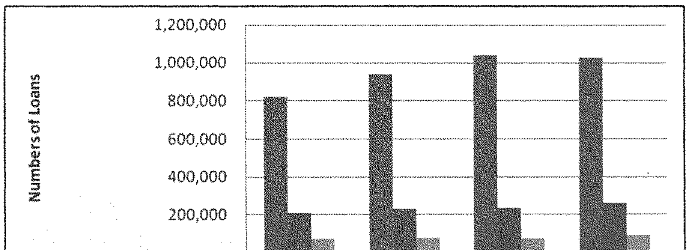
Nearly 300,000 loans are currently in some stage of foreclosure, up 8% between October and January. Furthermore, 133,000 foreclosures were completed in January, a 30% increase from October 2007. In our initial report, we expressed concern about a build-up of foreclosed home inventory on local home prices. We reiterate that concern based on the trends in foreclosures and increases in loans 90 days or more past due.

Finally, although not the focus of our efforts, we note with concern the increasing level of prime delinquencies in our data, and in other publicly available data. Weakness in prime loan quality will further strain the capacity of the larger servicers that manage both prime and subprime servicing portfolios.

B. Loss Mitigation and Loan Modification Efforts

The most troubling finding from our first report was the sheer number of seriously delinquent borrowers -- 7 out of 10 borrowers – that were not in any loss mitigation process to work out their situation. This finding has remained consistent over the subsequent three months of data.

Figure 2. Comparison between seriously delinquent (60+) loans and loss mitigation in process



	Oct	Nov	Dec	Jan
Severely delinquent loans*	819,639	938,159	1,040,290	1,025,508
Loss mitigation in process	209,520	229,682	237,583	260,899
Loss mitigation closed	76,047	78,525	74,898	89,548

* Severely delinquent loan total adjusted downward to account for two servicers not reporting loss mitigations in process.

The data through January confirms the finding from our first report that servicers have increased their use of loan modifications as a tool to enable homeowners to avoid foreclosure. While loan modifications in process increased 56% between October and January, repayment plans in process decreased 17% over the same time period, but overall, the percentage of "home retention" efforts in process remained unchanged (20% of seriously delinquent loans) between October 2007 and January 2008. Thus, servicers appear to be replacing short-term repayment plans with longer-term loan modifications.

In our first report, we divided loss mitigation efforts into three broad categories: 1) those where borrower loses the home (short sale and deed in lieu); 2) those where borrower retains the home (forbearance, repayment plan, or modification); and 3) those where borrower efforts lead to resolving the delinquency (refinance or reinstatement). The trend data, as seen in Table 1 below, show no change in the relative proportions of these efforts over this four-month period.

Table 1. Loss mitigation efforts, as a percent of total loans 60 or more days delinquent

Loss Mitigation Efforts	Jan 2008	Oct 2007
Total in process with borrower losing home	3.42%	3.42%
Total in process of home retention	20.06%	20.17%
Total in process of being resolved by borrower	1.95%	1.97%
Total loans in loss mitigation	25.44%	25.56%

In short, while more loans are in loss mitigation and more are working toward loan modifications, the level and dispersion of loss mitigation efforts in January is nearly identical to that of October 2007.

Closed Loss Mitigations

As noted above, after the publication of our first report, various servicers revised their data to improve consistency of the reporting or to correct for errors in initial reporting. As a result, the number of closed modifications due to reinstatement was dramatically reduced. While our first report highlighted the disparity between the "in process" and "closed" categories, the revised data in Table 2 show a much smaller gap between the two categories.

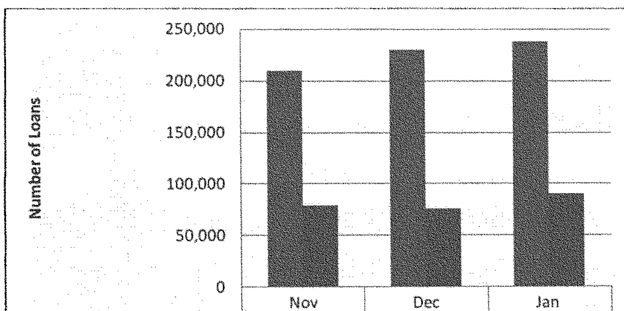
Table 2. Loss mitigation efforts in process versus loss mitigation efforts closed for month of January 2008.

Loss Mitigation Effort	In Process	Closed
Deed in lieu	1.4%	0.4%
Short sale	12.1%	4.4%
Forbearance	6.5%	3.9%
Repayment plan	19.0%	26.9%
Modification	53.4%	27.1%
Refinance or paid in full	2.0%	12.9%
Reinstatement	5.7%	24.4%
Total	100.0%	100.0%

While not as stark as our first report, the data still shows that a quarter of loss mitigation cases are closed due to borrowers catching up on past payments.

One explanation for the proportional differences between "in process" and "closed" modifications is the numbers of loss mitigations in process that fail to close. Through January 2008, closed loss mitigation efforts accounted for less than 40% of loss mitigations in process in the prior month. See Figure 3.

Figure 3. Comparison between loss mitigations closed and prior month's loss mitigations in process.



	Nov	Dec	Jan
■ Prior month's "in process"	209,520	229,682	237,583
■ Closed	78,525	74,898	89,548

This rate of fall-out is a significant concern. Loss mitigation proposals do not close for a variety of reasons; one reason is the level of paperwork required to close a loan modification. Servicers have told us that borrowers simply do not return the required documentation to complete the modification, and borrowers and counselors have reported that servicers lose paperwork they have sent in to the servicer. Regardless of where the problem arises, it appears that the level of paperwork required is a barrier to preventing unnecessary foreclosures.

Types of Loan Modifications

We are still working toward better reporting on types and duration of loan modifications, but we are able to make some general observations. First, we see a fairly even split between loan modifications that are permanent, life-of-loan changes and modifications that have a shorter duration. Freezing the interest rate at the starter/initial rate on an adjustable rate loan is the most common loan modification. There are significant numbers of interest rate modifications that fall below the starter/initial rate and a larger number that are above the starter rate (but below the reset rate). The majority of servicers are not reporting significant levels of modifications that reduce principal alone, although principal reductions may be combined with other modifications and therefore may not evidenced in our reporting.

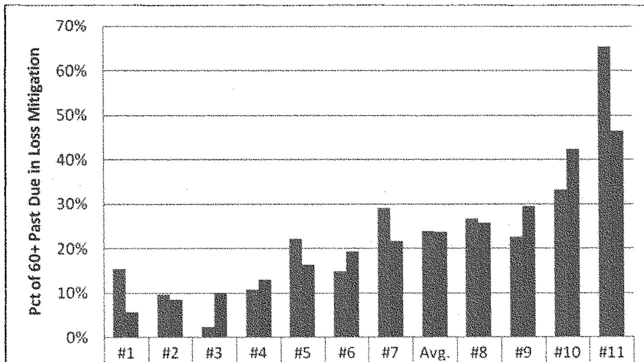
C. Variations Among Servicers

As noted in the first report, subprime servicing is not a monolith. Servicers differ as to their size, their level of specialization in subprime servicing, and their affiliations with mortgage originators. Our report found a significant variation among servicers in the types of modifications offered and the percentage of seriously delinquent borrowers in loss mitigation.

In January 2008, loan modifications were the most used loss mitigation technique for five of the 13 Reporting Servicers, closely followed by repayment plans by 4 of the 13 and reinstatement by 3 of the 13. This shows a slight shift toward loan modifications from the former use of repayment plans.

The data continue to show a wide disparity among levels of loss mitigations in process (Figure 4 below); however, there has been some compression of the disparity. Higher-performing servicers from October have some deterioration in their metrics and other servicers have raised their level of loss mitigation.

Figure 4: Loss mitigations in process for 11 Reporting Servicers in October 2007 versus January 2008, as a percentage of 60+ days past due



	#1	#2	#3	#4	#5	#6	#7	Avg.	#8	#9	#10	#11
Oct 07	15%	9%	2%	11%	22%	15%	29%	24%	27%	22%	33%	65%
Jan 08	6%	8%	10%	13%	16%	19%	21%	24%	26%	29%	42%	46%

Trends in Key Metrics Among Individual Servicers

With individual company data over this four month period, the State Working Group can begin to identify trends occurring at individual servicers.

Six of 11 servicers reporting loss mitigations in process saw a decline in seriously delinquent loans in loss mitigation between October 2007 and January 2008, with most of these being double-digit declines. At the same time, five servicers had impressive increases in their rates of loss mitigation. We have encouraged servicers to increase their loss mitigation capacity and it appears that some have made strides forward.

While almost every servicer saw an increase in subprime and Alt-A loans 90 or more days delinquent, the ones that had the largest increases in delinquency rates tended to show the biggest deterioration of borrower contact over this period.

Ten of the 11 servicers reporting loss mitigations in process showed increases in their use of loan modifications. Some of these increases were dramatic, with five servicers demonstrating increases of over 100% in loan modifications over the four month period.

Conclusion

Between October 2007 and January 2008, the mortgage industry established the HOPE NOW Alliance and devoted significant effort to increase public awareness of the resources to prevent foreclosures, to reach borrowers that had been difficult to reach, and to develop new approaches to modify loans more quickly. In addition, the HOPE NOW Alliance has developed a series of data collection projects that we hope will improve the ability to analyze servicer performance.

As of the end of January, these efforts have not yet made a major difference in preventing unnecessary foreclosures. The vast majority of homeowners with seriously delinquent loans are not on track for a loan work-out of any type. These loans are moving through the system toward foreclosure, leaving investors with increasing inventories of foreclosed homes. Servicers are increasing their use of loan modifications, but this increase is matched by increases in delinquency. Initial efforts to develop systemic approaches are far too limited to make a difference in preventable foreclosures.

In our previous report, we discussed the refusal of some national banks to provide servicing data, with two citing the advice of the Office of the Comptroller of the Currency (OCC). We called on the OCC to encourage national bank servicers to work voluntarily with the states in this foreclosure crisis. On February 29, 2008, the Comptroller announced that some of the largest national banks will be providing mortgage servicing data to the OCC on a monthly basis. We encourage the OCC to aggregate and publish data collected from national banks to complement the State Working Group's efforts.

The State Working Group will continue to work with servicers to promote systematic solutions to modify loans in a more streamlined and efficient manner. Without a systematic approach, we see little likelihood that ongoing efforts will make a serious dent in the level of unnecessary foreclosures.

APPENDIX A

CONSOLIDATED STATE REPORT FOR MORTGAGE SERVICERS
DATA AS OF JANUARY 31, 2008

Consolidated State Report for Mortgage Servicers

Consolidated Report as of January 31, 2008 for 13 Companies

All dollar amounts are the unpaid principal balance (UPB) and are in thousands (000's).
All numbers of loans are the actual number.

OPERATIONAL PROFILE	Number	%	UPB	%
Total Loans Serviced	15,470,743	100.00%	2,426,570,587	100.00%
Serviced loans originated and funded by an unaffiliated party	8,407,090	54.34%	1,369,435,887	56.44%
Serviced loans where originator or funder is affiliated with the servicer	7,063,653	45.66%	1,057,134,700	43.56%
Serviced loans secured by owner-occupied residence*	12,949,454	83.70%	2,080,500,681	85.74%
Serviced loans for investment or second residence property*	2,520,653	16.29%	344,452,211	14.20%
Loans which are secured by a first mortgage only*	11,390,558	73.63%	2,110,826,723	86.99%
Loans which are secured by a second mortgage only*	1,459,966	9.44%	75,538,990	3.11%
Loans which you service both the first and second mortgage*	2,706,156	17.49%	260,177,860	10.72%
*Reported data reconciles within 2%.				
Prime Loans (8 servicers reporting)	10,266,475	100.00%	1,674,789,279	100.00%
Fixed rate, fully amortizing	7,288,708	71.00%	1,032,976,592	61.68%
Hybrid ARMs (2/28, 3/27s, or similar)	1,237,967	12.06%	324,340,123	19.37%
Adjustable rate, fully amortizing	919,100	8.95%	45,831,400	2.74%
Loans with interest only feature	435,318	4.24%	126,633,983	7.56%
Payment Option ARMs and other loans with negative amortization feature	384,111	3.74%	144,756,400	8.64%
Other	1,271	0.01%	250,780	0.01%
Subprime & Alt-A Loans (13 servicers reporting)	4,959,707	100.00%	781,393,399	100.00%
Fixed rate, fully amortizing	2,538,045	51.17%	300,620,148	38.47%
Hybrid ARMs (2/28, 3/27s, or similar)	1,527,204	30.79%	282,402,876	36.14%
Adjustable rate, fully amortizing	76,131	1.53%	16,399,259	2.10%
Loans with interest only feature	348,955	7.04%	96,367,730	12.33%
Payment Option ARMs and other loans with negative amortization feature	127,967	2.58%	47,591,008	6.09%
Other	341,405	6.88%	38,012,377	4.86%

DELINQUENCY BY QUARTER OF INITIAL RESET

Number of Prime Loans

		30+ Days Past Due		Individual Company %		
		Number	%	High	Low	Median
4th Quarter 2007	27,560	6,167	22.38%	24.23%	14.08%	20.39%
1st Quarter 2008	19,890	3,003	15.10%	15.59%	11.11%	14.34%
2nd Quarter 2008	24,110	2,343	9.72%	10.11%	5.00%	8.56%
3rd Quarter 2008	30,683	3,436	11.20%	21.74%	7.35%	13.75%
4th Quarter 2008	22,472	1,829	8.14%	8.15%	6.67%	8.08%
1st Quarter 2009	17,350	1,251	7.21%	16.67%	7.12%	7.68%
2nd Quarter 2009	31,476	1,540	4.89%	20.00%	3.06%	5.27%
3rd Quarter 2009	31,930	1,863	5.83%	8.33%	2.56%	4.80%
Eight Quarter Total	205,471	21,432	10.43%			
Percent of Total Serviced	2.00%					
Percent of non-fixed rate products	6.90%					

UPB of Prime Loans

		30+ Days Past Due		Individual Company %		
		UPB	%	High	Low	Median
4th Quarter 2007	7,829,075	1,706,244	21.79%	22.88%	16.40%	20.86%
1st Quarter 2008	5,045,128	815,638	16.17%	17.19%	7.91%	15.06%
2nd Quarter 2008	5,713,169	601,882	10.54%	11.06%	4.08%	9.30%
3rd Quarter 2008	7,243,717	881,514	12.17%	16.94%	7.88%	11.45%
4th Quarter 2008	5,121,770	454,590	8.88%	8.93%	6.85%	8.87%
1st Quarter 2009	3,929,751	317,272	8.07%	15.10%	7.87%	9.24%
2nd Quarter 2009	7,890,879	395,877	5.02%	28.07%	3.13%	5.39%
3rd Quarter 2009	7,653,209	484,401	6.33%	6.85%	2.15%	3.74%
Eight Quarter Total	50,426,698	5,657,418	11.22%			
Percent of Total Serviced	3.01%					
Percent of non-fixed rate products	7.86%					

DELINQUENCY BY QUARTER OF INITIAL RESET

Number of Sub-Prime & Alt-A Loans

		30+ Days Past Due		Individual Company %		
		Number	%	High	Low	Median
4th Quarter 2007	87,903	40,148	45.67%	61.28%	36.34%	48.44%
1st Quarter 2008	111,720	45,520	40.74%	54.36%	27.76%	41.32%
2nd Quarter 2008	141,486	52,256	36.93%	47.29%	26.34%	36.14%
3rd Quarter 2008	184,154	71,823	39.00%	48.97%	26.95%	38.88%
4th Quarter 2008	187,610	73,762	39.32%	52.95%	23.50%	38.49%
1st Quarter 2009	141,849	51,447	36.27%	45.91%	17.58%	36.42%
2nd Quarter 2009	93,161	27,955	30.01%	52.95%	17.96%	29.09%
3rd Quarter 2009	62,886	17,935	28.52%	45.32%	17.36%	30.05%
Eight Quarter Total	1,010,769	380,846	37.68%			
Percent of Total Serviced	20.38%					
Percent of non-fixed rate products	41.74%					

UPB of Sub-Prime & Alt-A Loans

		30+ Days Past Due		Individual Company %		
		Number	%	High	Low	Median
4th Quarter 2007	19,225,767	8,674,663	45.12%	63.45%	33.81%	51.10%
1st Quarter 2008	23,048,468	9,697,710	42.08%	57.57%	29.05%	43.85%
2nd Quarter 2008	28,787,426	11,145,312	38.72%	50.53%	25.92%	39.65%
3rd Quarter 2008	38,987,971	16,140,159	41.40%	52.53%	28.98%	40.72%
4th Quarter 2008	41,059,172	17,371,524	42.31%	56.42%	24.57%	41.33%
1st Quarter 2009	31,631,116	12,521,084	39.58%	59.45%	18.59%	39.29%
2nd Quarter 2009	20,601,372	6,552,705	31.81%	56.08%	18.83%	31.78%
3rd Quarter 2009	14,441,681	4,000,876	27.70%	46.55%	17.43%	26.94%
Eight Quarter Total	217,782,972	86,104,033	39.54%			
Percent of Total Serviced	27.87%					
Percent of non-fixed rate products	45.30%					

DELINQUENCY & DEFAULT

Number of Prime Loans	Number	Individual Company (% of Serviced) High	Low	Median
30 to 59 days	271,804	39.97%	0.22%	2.29%
60 to 89 days	104,091	18.95%	0.72%	1.01%
90 days or over	176,893	80.00%	1.22%	1.89%
Total	552,788			
Percentage of Prime Loans Serviced	*5.38%*	*132.04%*	*0.22%*	*4.70%*
Loans from above which were modified in the last 12 months.	5,822			
Percentage of total past due	*1.05%*	*6.28%*	*0.03%*	*1.68%*
Loans which entered delinquency within 3 payments of initial rate reset	362			
Percentage of total past due	*0.07%*	*3.87%*	*0.29%*	*2.08%*
Loans where notice of default sent	9,029			
Loans where formal foreclosure proceedings started	31,733			
Total Loans in Process of Foreclosure	40,762			
Percentage of total past due	*7.37%*	*79.23%*	*0.11%*	*16.61%*
Loans where foreclosure proceeding completed (ORE)	27,510			

UPB of Prime Loans	UPB	Individual Company (% of Serviced) High	Low	Median
30 to 59 days	39,279,638	4.29%	0.15%	1.39%
60 to 89 days	15,300,461	1.58%	0.20%	0.88%
90 days or over	19,921,597	75.87%	0.26%	1.32%
Total	74,501,696			
Percentage of Prime Loans Serviced	*4.45%*	*75.87%*	*0.15%*	*3.74%*
Loans from above which were modified in the last 12 months.	900,883			
Percentage of total past due	*1.21%*	*5.46%*	*0.00%*	*0.77%*
Loans which entered delinquency within 3 payments of initial rate reset	126,846			
Percentage of total past due	*0.17%*	*3.42%*	*0.15%*	*0.81%*
Loans where notice of default sent	3,546,386			
Loans where formal foreclosure proceedings started	6,499,468			
Total Loans in Process of Foreclosure	10,045,854			
Percentage of total past due	*13.48%*	*90.33%*	*0.27%*	*17.45%*
Loans where foreclosure proceeding completed (ORE)	5,980,112			

DELINQUENCY & DEFAULT

Number of Sub-Prime & Alt-A Loans	Number	Individual Company (% of Serviced) High	Low	Median
30 to 59 days	355,422	9.77%	4.04%	7.56%
60 to 89 days	190,795	5.70%	2.47%	3.65%
90 days or over	630,967	22.37%	3.89%	15.95%
Total	1,177,184			
Percentage of Sub-Prime & Alt-A Loans Serviced	*23.73%*	*37.84%*	*13.14%*	*27.95%*
Loans from above which were modified in the last 12 months.	32,148			
Percentage of total past due	*2.73%*	*25.67%*	*0.05%*	*1.10%*
Loans which entered delinquency within 3 payments of initial rate reset	37,072			
Percentage of total past due	*3.15%*	*11.74%*	*0.09%*	*2.61%*
Loans where notice of default sent	135,996			
Loans where formal foreclosure proceedings started	161,962			
Total Loans in Process of Foreclosure	297,958			
Percentage of total past due	*25.31%*	*59.33%*	*0.81%*	*24.27%*
Loans where foreclosure proceeding completed (ORE)	133,540			

UPB of Sub-Prime & Alt-A Loans	UPB	Individual Company (% of Serviced) High	Low	Median
30 to 59 days	54,936,175	10.21%	3.96%	6.88%
60 to 89 days	31,212,143	6.39%	2.56%	3.94%
90 days or over	100,543,239	25.99%	3.01%	18.09%
Total	186,691,556			
Percentage of Sub-Prime & Alt-A Loans Serviced	*23.89%*	*41.94%*	*12.07%*	*29.69%*
Loans from above which were modified in the last 12 months.	5,506,175			
Percentage of total past due	*2.95%*	*25.39%*	*0.05%*	*1.19%*
Loans which entered delinquency within 3 payments of initial rate reset	7,485,477			
Percentage of total past due	*4.01%*	*12.57%*	*0.14%*	*3.37%*
Loans where notice of default sent	23,982,676			
Loans where formal foreclosure proceedings started	28,664,809			
Total Loans in Process of Foreclosure	52,647,485			
Percentage of total past due	*28.20%*	*63.61%*	*0.75%*	*31.92%*
Loans where foreclosure proceeding completed (ORE)	27,138,584			

LOSS MITIGATION & MODIFICATIONS

Number of Loans In-Process	Number	%	Individual Company (% allocation) High	Low	Median
Deed in lieu	3,670	1.41%	2.47%	0.02%	0.55%
Short sale	31,450	12.05%	34.50%	3.39%	9.09%
Total in process with borrower losing home	35,120	13.46%			
*Percent of past due 60 days+**	*3.42%*		*7.02%*	*0.35%*	*1.72%*
Forbearance	16,947	6.50%	47.23%	0.31%	3.57%
Repayment plan	49,615	19.02%	54.49%	2.22%	17.93%
Modification (principal reduction, interest rate &/or term of debt)	139,191	53.35%	81.47%	9.14%	33.97%
Total in process of home retention	205,753	78.86%			
*Percent of past due 60 days+**	*20.06%*		*42.48%*	*1.80%*	*13.79%*
Refinance or paid in full	5,279	2.02%	48.10%	1.94%	2.45%
Reinstatement/Account to be made current	14,747	5.65%	69.74%	2.19%	2.76%
Total in process of being resolved by borrower	20,026				
*Percent of past due 60 days+**	*1.95%*		*7.70%*	*0.49%*	*2.26%*
Total loans in loss mitigation	260,899	100.00%			
*Percent of past due 60 days+**	*25.44%*		*46.46%*	*5.54%*	*19.30%*

UPB of Loans In Process	UPB	%	Individual Company (% allocation) High	Low	Median
Deed in lieu	884,842	1.73%	2.90%	0.01%	0.56%
Short sale	7,320,986	14.33%	37.81%	4.01%	10.73%
Total in process of borrower losing home	8,205,828	16.06%			
*Percent of past due 60 days+**	*5.19%*		*10.20%*	*0.48%*	*2.40%*
Forbearance	2,563,158	5.02%	46.61%	0.39%	3.15%
Repayment plan	8,866,965	17.35%	49.80%	3.11%	15.99%
Modification (principal reduction, interest rate &/or term of debt)	28,185,048	55.16%	81.21%	10.05%	36.47%
Total in process of home retention	39,615,171	77.54%			
*Percent of past due 60 days+**	*25.07%*		*46.52%*	*2.33%*	*14.90%*
Refinance or paid in full	1,008,996	1.97%	31.01%	0.06%	2.81%
Reinstatement/Account made current	2,262,896	4.43%	37.18%	1.38%	4.69%
Total in process of being resolved by borrower	3,271,891	6.40%			
*Percent of past due 60 days+**	*2.07%*		*8.41%*	*0.01%*	*2.34%*
Total loans in loss mitigation	51,092,890	100.00%			
*Percent of past due 60 days+**	*32.34%*		*52.48%*	*8.83%*	*24.03%*

**Denominator adjusted to remove two companies which do not currently track modifications in process.*

LOSS MITIGATION & MODIFICATIONS

Number of Loans Closed	Number	%	Individual Company (% allocation) High	Low	Median
Deed in lieu	339	0.38%	2.79%	0.03%	0.41%
Short sale	3,943	4.40%	24.87%	0.18%	4.26%
Total closed with borrower losing home	4,282	4.78%			
Forbearance	3,459	3.86%	11.65%	0.39%	2.92%
Repayment plan	24,096	26.91%	76.19%	1.31%	22.70%
Modification (principal reduction, interest rate &/or term of debt)	24,264	27.10%	88.95%	4.30%	23.74%
Total closed solutions with home retention	51,819	57.87%			
Refinance or paid in full	11,579	12.93%	48.10%	0.67%	2.79%
Reinstatement/Account made current	21,868	24.42%	69.74%	2.19%	7.87%
Total closed with resolution by borrower	33,447	37.35%			
Total	89,548	100.00%			
Prepayment penalty waived (from any of the above)	335				

UPB of Loans Closed	UPB	%	Individual Company (% allocation) High	Low	Median
Deed in lieu	75,852	0.55%	2.67%	0.03%	0.51%
Short sale	581,695	4.24%	26.85%	0.05%	4.01%
Total closed with borrower losing home	657,547	4.79%			
Forbearance	516,953	3.77%	13.64%	0.55%	2.60%
Repayment plan	3,901,565	28.42%	76.26%	0.95%	26.40%
Modification (principal reduction, interest rate &/or term of debt)	4,469,054	32.56%	90.47%	6.22%	25.65%
Total closed solutions with home retention	8,887,572	64.74%			
Refinance or paid in full	1,512,944	11.02%	44.85%	0.14%	2.07%
Reinstatement/Account made current	2,668,982	19.44%	68.29%	1.12%	6.42%
Total closed with resolution by borrower	4,181,926	30.46%			
Total	13,727,046	100.00%			
Prepayment penalty waived (from any of the above)	44,320				

	Number	Individual Company High	Individual Company Low	Individual Company Median
PROFILE OF MODIFICATIONS BY NUMBER OF LOANS				
Time horizon for **closed** loan modifications				
Modification effective for less than life of loan (e.g. 2 years)				
Modification effective for life of loan				
Did not report				
Types of modifications **closed**				
Modification by freezing interest rate at the initial/start rate				
Modification by reducing the interest rate below the initial/start rate				
Modification by reducing the interest rate below scheduled reset rate, but above start rate				
Modification with extension of term				
Modification with reduction in principal balance				
Modification using two or more of above modifications (e.g. rate reduction and term change)				
Other modification				
PROFILE OF MODIFICATIONS BY UPB OF LOANS				
Time horizon for **closed** loan modifications				
Modification effective for less than life of loan (e.g. 2 years)				
Modification effective for life of loan				
Did not report				
Types of modifications **closed**				
Modification by freezing interest rate at the initial/start rate				
Modification by reducing the interest rate below the initial/start rate				
Modification by reducing the interest rate below scheduled reset rate, but above start rate				
Modification with extension of term				
Modification with reduction in principal balance				
Modification using two or more of above modifications (e.g. rate reduction and term change)				
Other modification				

This data is in process of being collected and will be available in future releases.

Notes

For the individual company data, the Low and Average do not include companies which reported a zero value.

Number of Companies reporting a zero value in the following significant reporting items:

Delinquent sub-prime/Alt-A loans which entered delinquency within 3 payments of initial rate reset		2
In Process:	Deed in lieu	3
	Short sale	2
	Forebearance	5
	Repayment plan	2
	Modification	2
	Refinance or paid in full	6
	Reinstatement / account made current	4
Closed:	Deed in lieu	4
	Short sale	0
	Forebearance	2
	Repayment plan	1
	Modification	0
	Refinance or paid in full	0
	Reinstatement / account made current	0

APPENDIX B

CONSOLIDATED STATE REPORT FOR MORTGAGE SERVICERS
TREND DATA FROM OCTOBER 2007 TO JANUARY 2008

Trend Data from Consolidated State Report for Mortgage Servicers

All dollar amounts are the unpaid principal balance (UPB) and are in thousands (000's).
All numbers of loans are the actual number.

	January	December	November	October	Oct to Jan	Dec to Jan	Nov to Dec	Oct to Nov
					Percentage Change			
Number of Servicers Reporting	13	13	13	13				
Initial Rate Reset & Delinquency								
Percentage of loans scheduled for initial rate reset in the next 8 quarters which are currently 30+ days delinquent								
Prime	10.43%	9.65%	8.45%	7.36%				
Sub-Prime & Alt- A	37.68%	36.57%	34.13%	30.74%				
DELINQUENCY & DEFAULT								
Number of Prime Loans								
30 to 59 days	271,804	297,434	245,242	238,446	13.99%	-8.62%	21.28%	2.85%
60 to 89 days	104,091	110,043	88,619	88,202	18.01%	-5.41%	24.18%	0.47%
90 days or over	176,893	185,104	128,608	62,073	184.98%	-4.44%	43.93%	107.19%
Total	552,788	592,581	462,469	388,721	42.21%	-6.72%	28.13%	18.97%
Percentage of Prime Loans Serviced	5.38%	5.78%	4.60%	3.78%				
Loans from above which were modified in the last 12 months.	5,822	6,659	5,848	5,348	8.86%	-12.57%	13.87%	9.35%
Percentage of total past due	1.05%	1.12%	1.26%	1.38%				
Loans which entered delinquency within 3 payments of initial rate reset	362	378	304	310	16.77%	-4.23%	24.34%	-1.94%
Percentage of total past due	0.07%	0.06%	0.07%	0.08%				
Loans where notice of default sent	9,029	11,269	8,921	9,538	-5.34%	-19.88%	26.32%	-6.47%
Loans where formal foreclosure procedings started	31,733	35,502	31,616	28,433	11.61%	-10.62%	12.29%	11.19%
Total Loans in Process of Foreclosure	40,762	46,771	40,537	37,971	7.35%	-12.85%	15.38%	6.76%
Percentage of total past due	7.37%	7.89%	8.77%	9.77%				
Loans where foreclosure preceding completed (ORE)	27,510	26,707	27,293	23,944	14.89%	3.01%	-2.15%	13.99%

DELINQUENCY & DEFAULT

UPB of Prime Loans	January	December	November	October	Oct to Jan	Dec to Jan	Nov to Dec	Oct to Nov
30 to 59 days	39,279,638	43,111,094	38,996,319	36,413,811	7.87%	-8.89%	10.55%	7.09%
60 to 89 days	15,300,461	16,357,821	14,720,023	14,258,173	7.31%	-6.46%	11.13%	3.24%
90 days or over	19,921,597	22,873,507	19,863,859	9,125,764	118.30%	-12.91%	15.15%	117.67%
Total	74,501,696	82,342,422	73,580,201	59,797,748	24.59%	-9.52%	11.91%	23.05%
Percentage of Prime Loans Serviced	4.45%	5.10%	4.64%	3.73%				
Loans from above which were modified in the last 12 months.	900,883	1,043,653	905,780	813,347	10.76%	-13.68%	15.22%	11.36%
Percentage of total past due	1.21%	1.27%	1.23%	1.36%				
Loans which entered delinquency within 3 payments of initial rate reset	126,846	134,092	106,337	112,468	12.78%	-5.40%	26.10%	-5.45%
Percentage of total past due	0.17%	0.16%	0.14%	0.19%				
Loans where notice of default sent	3,546,386	4,345,082	3,531,460	3,802,116	-6.73%	-18.38%	23.04%	-7.12%
Loans where formal foreclosure procedings started	6,499,468	7,351,150	6,465,924	5,783,470	12.38%	-11.59%	13.69%	11.80%
Total Loans in Process of Foreclosure	10,045,854	11,696,232	9,997,384	9,585,585	4.80%	-14.11%	16.99%	4.30%
Percentage of total past due	13.48%	14.20%	13.59%	16.03%				
Loans where foreclosure preceding completed (ORE)	5,980,112	6,011,207	5,922,818	5,165,182	15.78%	-0.52%	1.49%	14.67%

DELINQUENCY & DEFAULT	January	December	November	October	Oct to Jan	Dec to Jan	Nov to Dec	Oct to Nov
Number of Sub-Prime & Alt-A Loans								
30 to 59 days	355,422	379,068	374,411	356,849	-0.40%	-6.24%	1.24%	4.92%
60 to 89 days	190,795	199,286	192,709	186,695	2.20%	-4.26%	3.41%	3.22%
90 days or over	630,967	618,158	660,203	542,723	16.26%	2.07%	-6.37%	21.65%
Total	1,177,184	1,196,512	1,242,292	1,086,267	8.37%	-1.62%	-3.69%	14.36%
Percentage of Sub-Prime & Alt-A Loans Serviced	23.73%	23.60%	24.00%	21.25%				
Loans from above which were modified in the last 12 months.	32,148	35,722	26,762	22,522	42.74%	-10.01%	33.48%	18.83%
Percentage of total past due	2.73%	2.99%	2.18%	2.07%				
Loans which entered delinquency within 3 payments of initial rate reset	37,072	33,047	31,857	30,986	19.64%	12.18%	3.74%	2.81%
Percentage of total past due	3.15%	2.76%	2.60%	2.85%				
Loans where notice of default sent	135,996	135,325	121,366	135,024	0.72%	0.50%	11.50%	-10.12%
Loans where formal foreclosure procedings started	161,962	160,104	153,181	140,203	15.52%	1.16%	4.52%	9.26%
Total Loans in Process of Foreclosure	297,958	295,429	274,547	275,227	8.26%	0.86%	7.61%	-0.25%
Percentage of total past due	25.31%	24.69%	22.37%	25.34%				
Loans where foreclosure preceding completed (ORE)	133,540	125,402	115,233	102,538	30.23%	6.49%	8.82%	12.38%

DELINQUENCY & DEFAULT

UPB of Sub-Prime & Alt-A Loans	**January**	**December**	**November**	**October**	**Oct to Jan**	**Dec to Jan**	**Nov to Dec**	**Oct to Nov**
30 to 59 days	54,936,175	57,991,375	57,715,248	54,777,258	0.29%	-5.27%	0.48%	5.36%
60 to 89 days	31,212,143	32,280,167	31,269,978	30,275,397	3.09%	-3.31%	3.23%	3.29%
90 days or over	100,543,239	97,393,169	103,140,085	82,763,152	21.48%	3.23%	-5.57%	24.62%
Total	186,691,556	187,664,711	192,125,312	167,815,807	11.25%	-0.52%	-2.32%	14.49%
Percentage of Sub-Prime & Alt-A Loans Serviced	23.89%	23.43%	23.87%	20.91%				
Loans from above which were modified in the last 12 months.	5,506,175	6,041,625	4,338,864	3,562,013	54.58%	-8.86%	39.24%	21.81%
Percentage of total past due	2.95%	3.22%	2.26%	2.12%				
Loans which entered delinquency within 3 payments of initial rate reset	7,485,477	6,356,556	5,846,870	5,378,363	39.18%	17.76%	8.72%	8.71%
Percentage of total past due	4.01%	3.39%	3.04%	3.20%				
Loans where notice of default sent	23,982,676	23,458,517	21,168,389	25,219,053	-4.90%	2.23%	10.82%	-16.06%
Loans where formal foreclosure procedings started	28,664,809	28,201,039	31,512,264	28,715,404	-0.18%	1.64%	-10.51%	9.74%
Total Loans in Process of Foreclosure	52,647,485	51,659,556	52,680,654	53,934,457	-2.39%	1.91%	-1.94%	-2.32%
Percentage of total past due	28.20%	27.53%	27.42%	32.14%				
Loans where foreclosure preceding completed (ORE)	27,138,584	25,128,957	22,022,922	19,080,954	42.23%	8.00%	14.10%	15.42%

LOSS MITIGATION & MODIFICATIONS	January	December	November	October	Oct to Jan	Dec to Jan	Nov to Dec	Oct to Nov
Number of Loans In-Process								
Deed in lieu	3,670	4,711	4,451	3,663	0.19%	-22.10%	5.84%	21.51%
Short sale	31,450	31,009	29,475	24,365	29.08%	1.42%	5.20%	20.97%
Total in process with borrower losing home	35,120	35,720	33,926	28,028	25.30%	-1.68%	5.29%	21.04%
Percent of past due 60 days+	3.42%	3.43%	3.62%	3.42%				
Forbearance	16,947	17,855	18,102	16,222	4.47%	-5.09%	-1.36%	11.59%
Repayment plan	49,615	49,059	59,447	59,991	-17.30%	1.13%	-17.47%	-0.91%
Modification (principal reduction, interest rate &/or term c	139,191	117,051	99,692	89,147	56.14%	18.91%	17.41%	11.83%
Total in process of home retention	205,753	183,965	177,241	165,360	24.43%	11.84%	3.79%	7.18%
Percent of past due 60 days+	20.06%	17.68%	18.89%	20.17%				
Refinance or paid in full	5,279	6,414	7,167	3,206	64.66%	-17.70%	-10.51%	123.55%
Reinstatement/Account to be made current	14,747	11,484	11,348	12,926	14.09%	28.41%	1.20%	-12.21%
Total in process of being resolved by borrower	20,026	17,898	18,515	16,132	24.14%	11.89%	-3.33%	14.77%
Percent of past due 60 days+	1.95%	1.72%	1.97%	1.97%				
Total loans in loss mitigation	260,899	237,583	229,682	209,520	24.52%	9.81%	3.44%	9.62%
Percent of past due 60 days+	25.44%	22.84%	24.48%	25.56%				

LOSS MITIGATION & MODIFICATIONS

UPB of Loans In Process	January	December	November	October	Oct to Jan	Dec to Jan	Nov to Dec	Oct to Nov
Deed in lieu	884,842	1,143,585	1,078,053	883,044	0.20%	-22.63%	6.08%	22.08%
Short sale	7,320,986	7,122,576	6,504,175	5,260,935	39.16%	2.79%	9.51%	23.63%
Total in process of borrower losing home	8,205,828	8,266,161	7,582,228	6,143,980	33.56%	-0.73%	9.02%	23.41%
Percent of past due 60 days+	5.19%	5.15%	5.16%	4.73%				
Forbearance	2,563,158	2,842,774	2,992,909	2,618,905	-2.13%	-9.84%	-5.02%	14.28%
Repayment plan	8,866,965	8,830,697	10,517,134	10,139,747	-12.55%	0.41%	-16.04%	3.72%
Modification (principal reduction, interest rate &/or term c	28,185,048	23,632,958	19,274,083	16,080,207	75.28%	19.26%	22.62%	19.86%
Total in process of home retention	39,615,171	35,306,428	32,784,125	28,838,858	37.37%	12.20%	7.69%	13.68%
Percent of past due 60 days+	25.07%	21.98%	22.31%	22.18%				
Refinance or paid in full	1,008,996	1,144,067	1,239,074	704,512	43.22%	-11.81%	-7.67%	75.88%
Reinstatement/Account made current	2,262,896	1,804,164	1,756,235	2,052,634	10.24%	25.43%	2.73%	-14.44%
Total in process of being resolved by borrower	3,271,891	2,948,231	2,995,310	2,757,146	18.67%	10.98%	-1.57%	8.64%
Percent of past due 60 days+	2.07%	1.84%	2.04%	2.12%				
Total loans in loss mitigation	51,092,890	46,520,821	43,361,663	35,589,060	43.56%	9.83%	7.29%	21.84%
Percent of past due 60 days+	32.34%	28.96%	29.51%	27.37%				

LOSS MITIGATION & MODIFICATIONS	January	December	November	October	Oct to Jan	Dec to Jan	Nov to Dec	Oct to Nov
Number of Loans Closed								
Deed in lieu	339	317	275	356	-4.78%	6.94%	15.27%	-22.75%
Short sale	3,943	3,960	3,449	3,456	14.09%	-0.43%	14.82%	-0.20%
Total closed with borrower losing home	4,282	4,277	3,730	3,812	12.33%	0.12%	14.66%	-2.15%
Forbearance	3,459	3,413	3,124	3,136	10.30%	1.35%	9.25%	-0.38%
Repayment plan	24,096	19,564	19,625	21,843	10.31%	23.16%	-0.31%	-10.15%
Modification (principal reduction, interest rate &/or term of debt)	24,264	19,935	22,154	19,082	27.16%	21.72%	-10.02%	16.10%
Total closed solutions with home retention	51,819	42,912	44,903	44,061	17.61%	20.76%	-4.43%	1.91%
Refinance or paid in full	11,579	9,327	11,186	8,573	35.06%	24.14%	-16.62%	30.48%
Reinstatement/Account made current	21,868	18,382	18,712	19,601	11.57%	18.96%	-1.76%	-4.54%
Total closed with resolution by borrower	33,447	27,709	29,898	28,174	18.72%	20.71%	-7.32%	6.12%
Total	89,548	74,898	78,525	76,047	17.75%	19.56%	-4.62%	3.26%
Percentage of the previous month's in-process	37.69%	32.61%	37.48%					
Prepayment penalty waived (from any of the above)	335	344	279	236	41.95%	-2.62%	23.30%	18.22%
UPB of Loans Closed								
Deed in lieu	75,852	74,832	56,470	71,679	5.82%	1.36%	32.52%	-21.22%
Short sale	581,695	513,220	433,173	618,663	-5.98%	13.34%	18.48%	-29.98%
Total closed with borrower losing home	657,547	588,052	489,643	690,343	-4.75%	11.82%	20.10%	-29.07%
Forbearance	516,953	495,766	421,588	443,615	16.53%	4.27%	17.60%	-4.97%
Repayment plan	3,901,565	3,017,291	3,031,761	3,358,630	16.17%	29.31%	-0.48%	-9.73%
Modification (principal reduction, interest rate &/or term of debt)	4,469,054	3,569,723	4,217,612	3,340,759	33.77%	25.19%	-15.36%	26.25%
Total closed solutions with home retention	8,887,572	7,082,780	7,670,960	7,143,004	24.42%	25.48%	-7.67%	7.39%
Refinance or paid in full	1,512,944	1,273,470	1,152,006	1,814,769	-16.63%	18.80%	10.54%	-36.52%
Reinstatement/Account made current	2,668,982	2,387,497	2,399,345	2,521,715	5.84%	11.79%	-0.49%	-4.85%
Total closed with resolution by borrower	4,181,926	3,660,967	3,551,351	4,336,484	-3.56%	14.23%	3.09%	-18.11%
Total	13,727,046	11,331,800	11,711,954	12,169,830	12.80%	21.14%	-3.25%	-3.76%
Percentage of the previous month's in-process	29.51%	26.13%	32.91%					
Prepayment penalty waived (from any of the above)	44,320	37,821	19,691	14,500	205.65%	17.18%	92.07%	35.80%

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

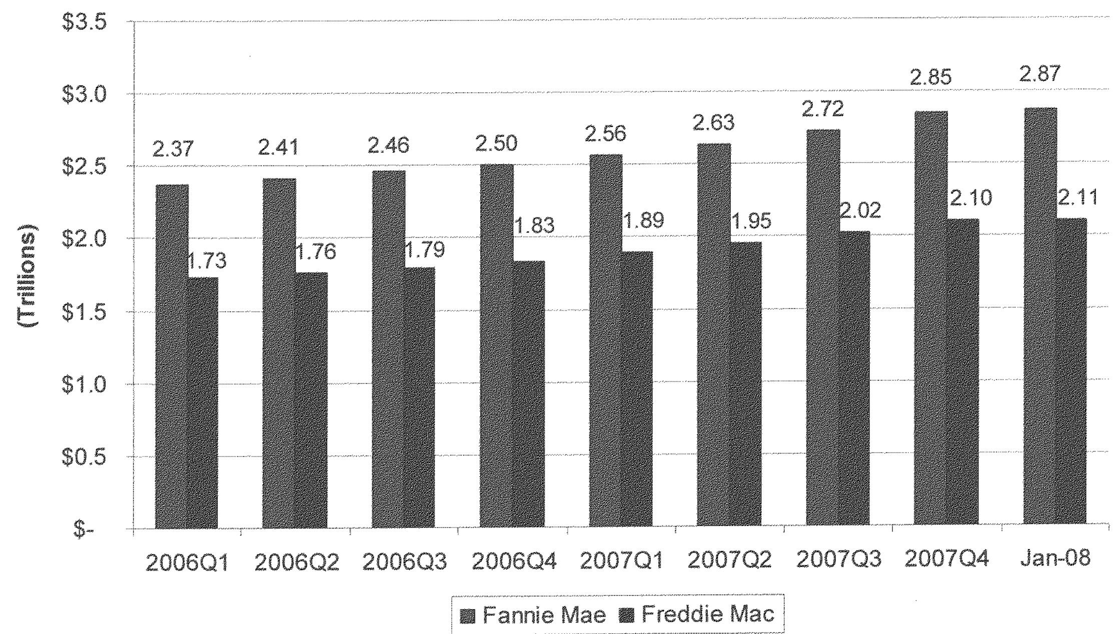
Financial Condition of the Enterprises

Briefing to Staff of Senate Committee on Banking, Housing, and Urban Affairs

March 4, 2008

Enterprises' Total Book of Business

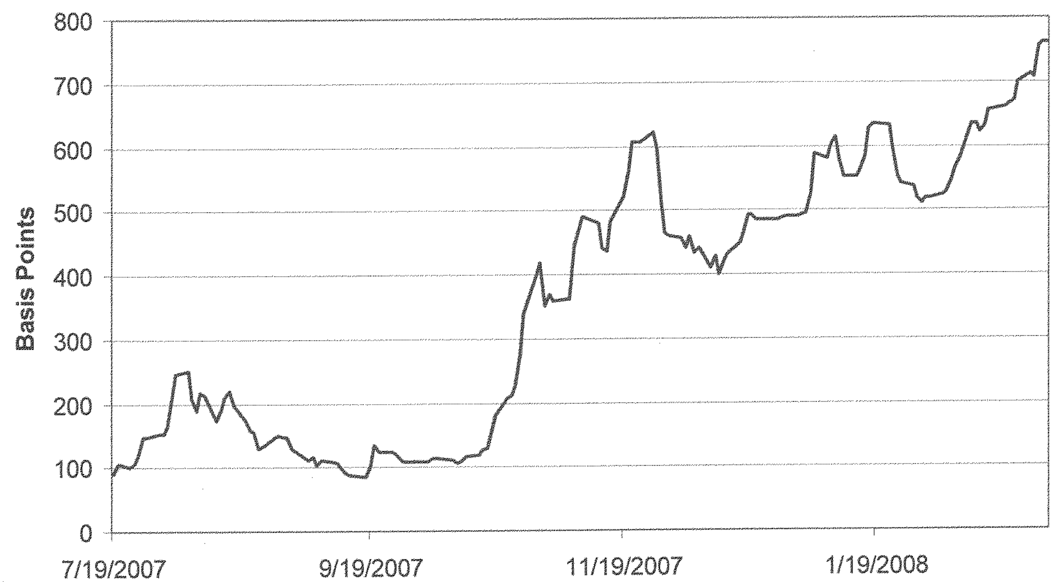
OFHEO



ABX 07-1 AAA Spread

July 19, 2007 - February 29, 2008

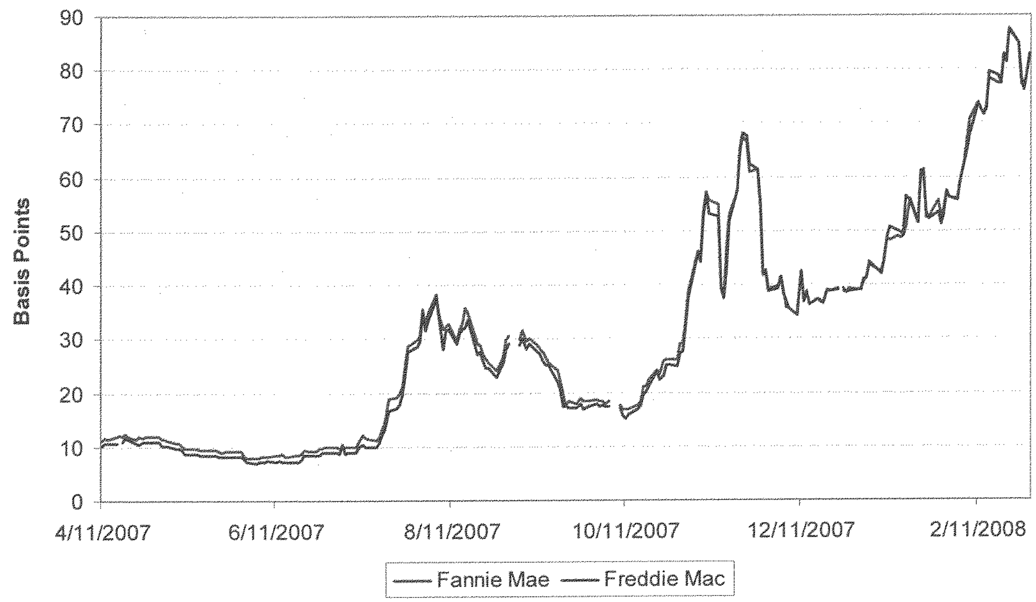
OFHEO



Five-Year Credit Default Swap Spreads

April 11, 2007 - February 29, 2008

OFHEO



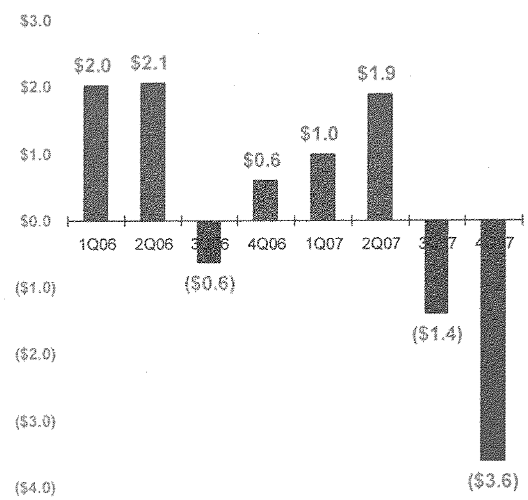
Quarterly Earnings – 2 Year History

OFHEO

Both Enterprises reported significant net losses in the second half of 2007; continuing a trend of volatile and unattractive financial results over the past several quarters.

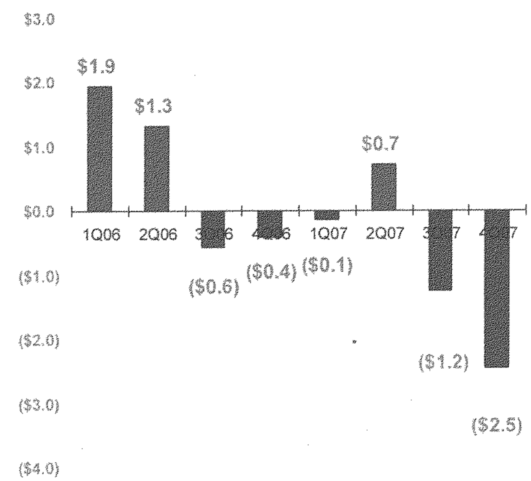
Fannie Mae

Net Income
($ billions)



Freddie Mac

Net Income
($ billions)



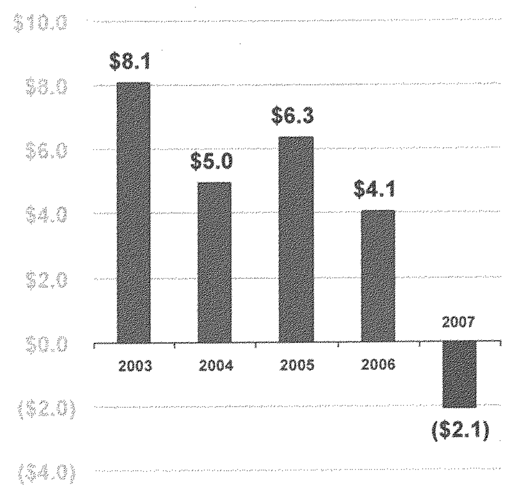
Annual Earnings – 5 Year History

OFHEO

2007 was a very challenging year for the Enterprises; reflecting a sharp decline in financial results that have weakened over the past five years. Both Enterprises reported annual net losses. Freddie Mac has never reported an annual net loss until 2007. Fannie Mae's last reported annual net loss was in 1985.

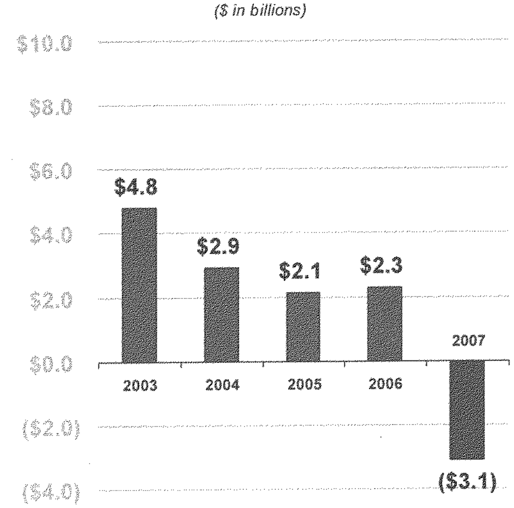
Fannie Mae

Net Income - 5 Year History
($ in billions)



Freddie Mac

Net Income - 5 Year History
($ in billions)



Earnings Analysis – 5 Year History

OFHEO

From 2003 through 2006, declines in revenue and volatile interest-rate related expenses were the primary drivers of earnings deterioration. After years of benign credit losses, credit related expenses emerged at unprecedented levels in 2007.

Net Income – Five Year History

	GAAP Earnings $ billions	Fannie Mae 2003	2004	2005	2006	2007	Freddie Mac 2003	2004	2005	2006	2007
Revenues	**Total Revenues**	23.1	22.5	16.3	12.0	11.2	12.0	10.9	6.8	6.0	6.0
Interest rate	**Total Int.rate-related Items**	(9.5)	(12.7)	(3.7)	(1.4)	(4.8)	(1.9)	(4.7)	(1.2)	(0.3)	(2.8)
Credit-related	**Total credit-related Items**	(1.1)	(0.9)	(1.8)	(2.1)	(7.3)	(0.9)	(0.2)	(0.6)	(1.2)	(6.8)
Expenses	**Total Expenses**	(2.2)	(3.0)	(3.2)	(4.3)	(4.3)	(2.2)	(2.2)	(2.5)	(2.3)	(2.4)
Pre-Tax Income		$10.3	$6.0	$7.6	$4.2	($5.1)	$7.0	$3.7	$2.5	$2.3	($6.0)
Taxes	**(Provision) Benefit for Taxes**	(2.4)	(1.0)	(1.3)	(0.2)	3.1	(2.2)	(0.8)	(0.4)	0.0	2.9
	Extraordinary gains (losses)	0.2	(0.0)	0.1	0.0	(0.0)	-	-	-	-	-
	Change in accounting principle	0.0	-	-	-		-	-	(0.1)	-	-
Net Income		$8.1	$5.0	$6.3	$4.1	($2.1)	$4.8	$2.9	$2.1	$2.3	($3.1)
	Preferred stock dividends	(0.15)	(0.17)	(0.49)	(0.51)	(0.51)	(0.22)	(0.21)	(0.22)	(0.27)	(0.40)
Net Income to common stockholders		$7.9	$4.8	$5.9	$3.5	($2.6)	$4.6	$2.7	$1.9	$2.1	($3.5)
	Shares outstanding (Diluted)	981.0	973.0	998.0	972.0	975.0	688.7	691.5	693.5	682.7	651.9
	Earnings Per Share (Diluted)	$8.08	$4.94	$5.87	$3.65	($2.63)	$6.67	$3.94	$2.73	$3.01	($5.37)

Accounting Changes at Freddie Mac

OFHEO

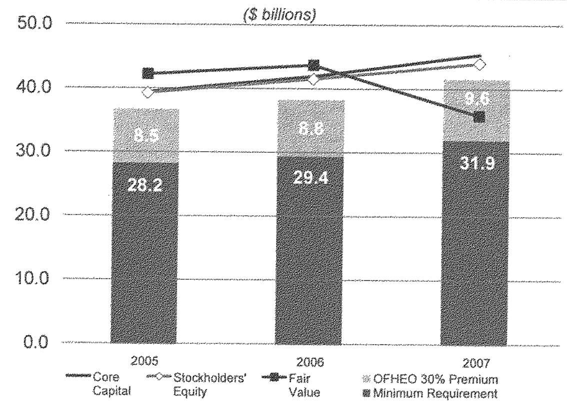
- FRE made two changes to its guarantee accounting:
  - Non-Extinguishment – No longer extinguishes guarantee accounts for FRE PCs that it owns. Continues to account for guarantees separately, now similar to FNM.
  - Changed method of amortizing guarantee obligation.
  - Both changes increased core capital (cumulative impact of $1.3 billion on 12/31/07), but FRE cites other reasons for change.
- FRE adopted FAS 159, which permits discretion regarding which securities to elect at adoption, by electing securities that had unrealized gains of $1billion.

Comparison of Capital Metrics

OFHEO

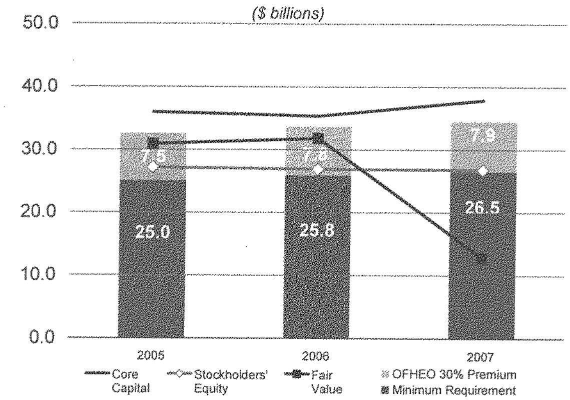
The Enterprises capital levels may be measured in several ways. Both Enterprises raised substantial levels of preferred stock in the fourth quarter raising the proportion of preferred stock in core capital significantly.

Fannie Mae



	2005	2006	2007
Core Capital	39.4	42.0	45.4
Stockholders' Equity	39.3	41.5	44.0
Fair Value	42.2	43.7	35.8
Capital Surplus	2.7	3.8	3.9
Preferred Stock /Core Capital	23.1%	21.7%	37.3%

Freddie Mac



	2005	2006	2007
Core Capital	36.0	35.4	37.9
Stockholders' Equity	27.2	26.9	26.8
Fair Value	30.9	31.8	12.8
Capital Surplus	3.5	1.8	3.5
Preferred Stock /Core Capital	13.2%	17.3%	37.3%

Fair Value Performance

OFHEO

The Enterprises fair value of net assets declined considerably in 2007 as market perceptions of higher future losses were reflected in lower market prices for mortgage loans and securities and higher prices for the obligation to guarantee payments on mortgage-related securities.

	Fannie Mae			Freddie Mac		
($ in billions)	**2006**	**2007**	**Change**	**2006**	**2007**	**Change**
Total Assets	$846.4	$893.5	$47.1	$803.1	$799.9	($3.2)
Total Liabilities	802.7	857.7	$55.0	771.3	787.3	$16.0
Fair Value of Net Assets	**$43.7**	**$35.8**	**($7.9)**	**$31.8**	**$12.6**	**($19.2)**
Preferred Stock	9.0	15.3	6.3	5.8	12.3	6.5
Common Stock	34.7	20.5	(14.2)	26.0	0.3	(25.7)

Very High Mortgage Credit Leverage

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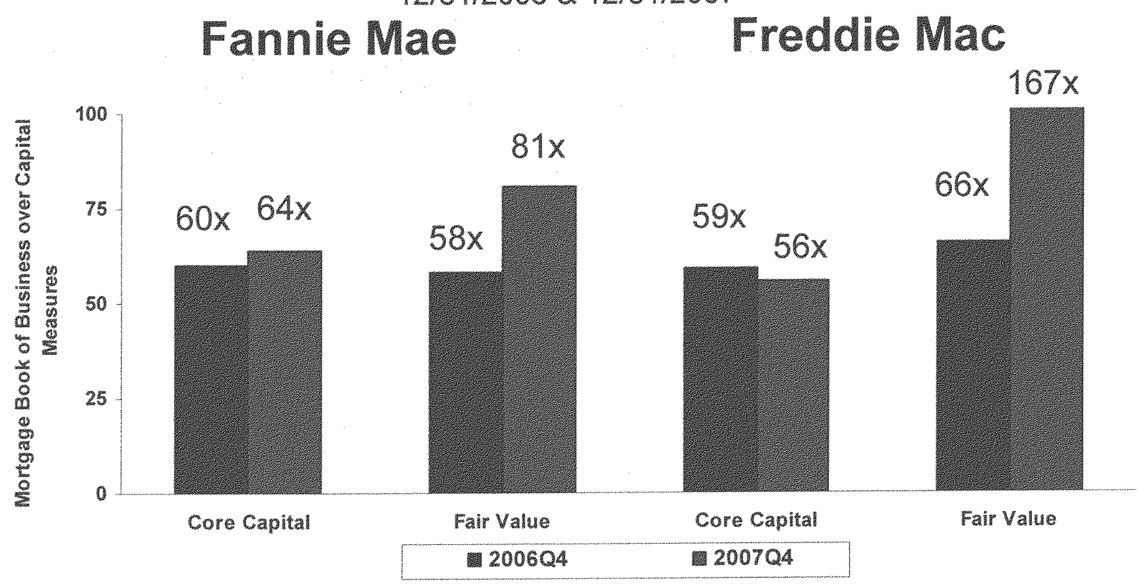
12/31/2006 & 12/31/2007



During 4Q07, Fannie Mae raised $7.9 billion and Freddie Mac $6 billion in preferred stock. Mortgage credit leverage is still very high.